

JULY 1959

VOL. XXIX NO. 7

The President's Page

Continuing Education

•

The Relationship of
Law and Accounting

•

Motor Hotels and
Market Studies

•

Actuarial Principles
and Pension Plans

•

Paperwork Simplification

•

Regular Departments



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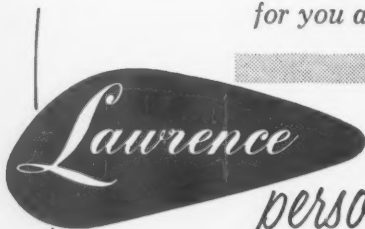
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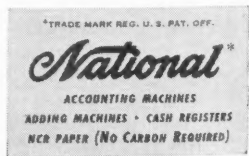
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THE NEW YORK CPA



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Volume XXIX

No. 7

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Accounting News And Trends

EXECUTIVE COMPENSATION AND TAX POLICY

As the first volume of a projected series on "The Impact of Taxation on Management Responsibility" the Tax Institute (457 Nassau St., Princeton, N. J.) has published "The Effect of Tax Policy on Executive and Worker Compensation." (80 pages; price \$4.00.) A panel of 13 participants, representing diverse fields of tax interest, met in a one-day seminar and this book contains a revised and edited transcription of the proceedings together with a summary of the discussion.

Some of the observations made by panel members, particularly the CPAs, may be of interest.

1. Since the tremendous increase in the number of employees covered by pension and profit-sharing plans (now about one-quarter of the civilian non-agricultural labor force) has taken place during the high income tax period, several members stated that tax considerations were an important motivating factor. One CPA disagreed pointing out that the growth could be attributable to "the concern with security which seems to have hit the country in the last 25 years."

2. Deferred compensation plans may result in no tax saving to an individual participant because the deferred income is earned over a relatively large number of years when the employee is at his lowest earning capacity and paid out to him over a

short period after retirement. Thus the effective tax rate on the deferred income may be increased.

3. The high tax rates have made management feel more liberal in granting salary increases and the relaxation of restraints in salary control has become fairly widespread.

4. The varied systems of deferred compensation make it extremely difficult to determine the exact amount of compensation. One CPA remarked that the accountant has a "terrific time" establishing the proper amount of salary and the issue is so confused that regardless of what is published in the proxy statements "very few stockholders have any idea of what they are paying their executives."

5. Nearly all accepted the view that deferred compensation plans have severely reduced executive and worker mobility.

6. There was general agreement that the special provisions of the Code with respect to deferred compensation have somewhat mitigated the effect of the high tax rates for employed persons. The burden thus falls more heavily on the self-employed. One interesting point was raised by a CPA who pointed out that when a man in his firm is advanced to partnership status, he has to forfeit his contribution to the plan exactly as though he had been laid off.

DIRECT COSTING

The extent to which direct costing is being used was recently checked on by the Controllershship Foundation and reported in *THE CONTROLLER* (May 1959). In almost 400 companies surveyed the results showed that about 22 percent used direct costing and 78 percent did not.

ACCOUNTING NEWS AND TRENDS is conducted by **CHARLES L. SAVAGE**, CPA. He is presently serving as a member of our Society's Committee on Legislation. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

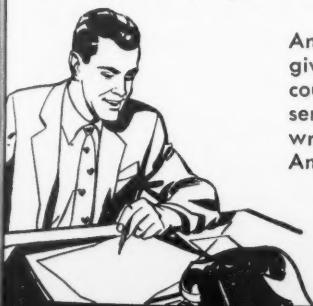
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Most of the companies using direct costing stated that they have employed this technique for ten years or less while only thirty percent have been using this method for more than ten years. Since some respondents indicated they consider direct costing an aid to effective budgeting and control of costs at the operating level or operating cost centers, these results suggest it might be worth while taking a second look at this accounting technique for sharpening budgetary and cost control.

IMPROVING CORPORATE ANNUAL REPORTS

There are still too many accountants who look upon their work in preparing annual reports as a routine and technical exercise that requires going through the same motions year after year according to Mr. Weston Smith's address to the Wisconsin Society of CPAs which is commented upon in *THE CONTROLLER* (May 1959). To make the annual report more meaningful, he suggested that the members of the accounting profession who participate in the preparation of corporate annual reports take the initiative and:

1. Recommend the publication of more breakdowns in the totals for sales (by products, divisions, or services); and for the cost of sales and expenses, showing separately wages and salaries, pensions and other benefits, administrative, selling and advertising expenses, research and development costs, depreciation and amortization; and

2. Include all possible percentages, averages and ratios which are appropriate to the industry involved, in order to serve the nominal requirements of security analysts and other investment professionals.

Operating and production statistics will depend on the nature of each in-

dust, but every company should be familiar with the specialized and appropriate figures that can be presented in its annual report. The resourceful accountant can initiate a variety of breakdowns by hours, days, weeks, months and quarters; geographically by nations, divisions, states or communities; and by markets, groups and individuals.

For both the average investors and the security analysts per-share figures are vital statistics. In addition to earnings and dividends, other per-share statistics are: book value (compared with previous years to be of real value); federal and other taxes for a series of years; and working capital.

Perhaps many of the modernized annual reports have been giving too much information up front, while neglecting many of the opportunities in the back or financial portion. Now it is up to the financial officers, accountants and independent auditors to do as good a job in providing more statistics. The author urges all members of the accounting profession to take the initiative in recommending the inclusion of more breakdowns, percentages, averages and ratios in the annual report.

PRACTICAL APPLICATIONS OF PROFESSIONAL CONDUCT

The Committee on Professional Conduct of the Illinois Society of CPAs continues to render valuable service to the profession with the publication of its first case studies designed to supplement its opinions on the application of the rules of professional conduct to particular situations (THE ILLINOIS SOCIETY OF CPAs NEWSLETTER, April 1959). To the average CPA, these rules sometimes lack precise meaning until they are

applied to particular facts and it is to be hoped that the publication of these cases will be continued and that the practice will be followed by other State CPA Societies.

Examples of some cases involving the rule with respect to advertising follow:

1. The name of a firm of CPAs (whose partners are Society members) had been printed on the letterhead of a client (a charitable organization) without the knowledge or consent of the firm. The firm was requested to cause its name to be removed from future letterheads of the client. (In a similar case, a firm's name appeared in the annual report of a charity—not in connection with the audit—as having contributed the audit. The firm was asked to request its client to discontinue this practice.)

2. The legend "Income Tax Service" appeared on the street-level office window of a member. The member was informed that "Certified Public Accountant(s)" was sufficient and he agreed to remove the sign. (In a similar case a member had used and was asked to remove the words "Tax Consultant" which had appeared in addition to "Certified Public Accountant.")

3. A firm, whose partners are members, had sent calendars bearing the firm name and the identification "Certified Public Accountants" to clients and others. The Committee ruled that sending such calendars even to clients was a breach of good taste and that sending them to non-clients was advertising.

4. A member inquired as to the propriety of placing a lawyer's name on his firm's letterhead and the Committee found that this would be a violation of the rules of professional conduct.

Letters to the Editor

PREPARATION OF A UNIFORM SYSTEM OF ACCOUNTS AS A SPECIAL ENGAGEMENT

I think some of your readers may be interested in a recent assignment where we were engaged to prepare a uniform system of accounts for the food service equipment industry. The need for a uniform system of accounts for this industry was apparent after an effort to compile nation-wide operating statistics for the industry. The task of compiling these statistics was delegated to our firm on two occasions, and the variety of data submitted to us for analysis was, to say the least, bewildering. Despite the very lively interest in the operating statistics when they were finally compiled, the response to the request of the Industry Committee for submission of data was very disappointing—so disappointing, in fact, that we had serious doubts as to the validity of the statistics finally developed. It was our opinion that the fundamental reason why the response was so small was that there was no standard of recording in the industry that would permit ready compilation of required data by the member firms, even on a questionnaire basis. The Industry Committee concurred in this opinion and took the initiative in securing the approval of the Association for the formulation of a uniform system of accounts. The project was underwritten by Ahrens Publishing Co., the publisher of the industry's magazine, *THE RESTAURANT EQUIPMENT DEALER*, and our firm was engaged to do the basic research and formulate the system.

Our first endeavor was to secure data on the accounting methods and charts of accounts used by firms in the industry. The Industry Committee

arranged interviews with operators, their controllers and accountants throughout the country, for men from our offices in New York, Boston, Chicago, Houston, Atlanta and Los Angeles. The charts of accounts, pro-forma statements and digests of accounting procedure thus compiled were forwarded to New York for analysis.

From this analysis, and from other data obtained through conferences with industry personnel, we were able to deduce the general operating dynamics of the business. Using the tabulation of incidence of specific accounts compiled from the data submitted, and on the basis of the deduced dynamics of the industry, we developed a set of pro-forma statements. These statements were subjected to critical appraisal using the following criteria:

1. Correspondence of balance sheet data with standards of the American Institute.
2. Completeness of direct costing to each phase of the operation.
3. Adequacy of the system in solving the particular problems of the industry.

It was through the application of these criteria to the first set of pro-forma statements that we developed the actual account sequence and procedural specifications incorporated into the system.

The operating phases of the business, as deduced from the analysis of pro-forma statements and other data, were represented by generic accounts, as follows:

- Sales
- Cost of Goods Sold
- Warehouse and Delivery
- Selling Expenses
- Administration

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Specific accounts were arranged in logical sequence within these generic groupings, and an additional generic account for employee relations was established, within which were included specific accounts for payroll taxes, workmen's compensation insurance, union pension contributions, etc., specifying procedures for distribution of these expenses to the other generic accounts. Salaries and wages are to be charged to a clearing account from the disbursement voucher, and distributed to specific accounts within the relevant generic groups by standard journal entry. This journal entry will be so compiled that the residual balance in the payroll clearing account will reflect a valid accrual, thus eliminating the necessity for adjusting entries.

All standards of recording specified were oriented to the production of monthly statements, which we consider to be indispensable guides to management.

Since uniform systems of accounts are lacking in many businesses and industries, here is a further opportunity for accountants to serve their clients with mutually beneficial results.

JOSEPH BRODNER, CPA
(Harris, Kerr, Forster & Company)
New York, N. Y.

ARE OUR CLIENTS REALLY INSURED?

Some months ago a couple of brothers had their plant destroyed by fire. They collected for the full value of the destroyed plant and contents but suddenly woke up to the fact that they were suffering a terrific loss. They couldn't buy a new plant. It would take many months to build a new one. And until they got a new one, they could do no business and make a living. They were really up against it. What they needed, and did not have,

was "use and occupancy insurance" or its running mate "profit insurance."

Who was to blame for this? Ultimately, the men who sustained the loss. Their broker had recommended the proper kinds, but had been put off with the "can't afford it" excuse. True, that kind of insurance is not cheap, in immediate dollars. But the broker, fearful of losing an account, did not press the matter. It should be noted that until after the fire, no CPA was employed.

This incident is cited to show that most people do not have enough of the right kinds of insurance. Yes, some people have too much of the wrong kinds, but they are rare exceptions. The primary purpose of this letter, however, is to point out that some much-needed kinds of insurance can't be had at all. It is hoped that the readers will take it up with their clients and insurance brokers so that something will be done about it. Here is an illustration of what we mean.

Last year, the writer sustained a fall that painfully injured one arm. An accident policy, in due course, paid for the X-rays and for the medical treatments. So far, fine! But the big expense of that accident was barbers. Yes, barbers! Did you ever try to shave yourself with one arm in a sling? No matter what kind of razor you use, the skin of the face must be held taut by one hand, while the razor is in the other. So the writer had to get shaved; and in the city where he lives that costs \$1.25. He could not offend people he met in business by looking like a "weary Willie." The writer has another accident policy too. That one also would not pay for barbering.

What have the readers of this letter done to make their clients aware of these matters?

LEWIS GLUICK, CPA
Miami, Florida

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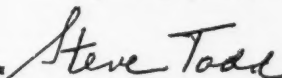
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Book Reviews

COST JUSTIFICATION

By Herbert F. Taggart. BUREAU OF BUSINESS RESEARCH, THE UNIVERSITY OF MICHIGAN, Ann Arbor, Michigan, 1959. Pages: xvi + 588; \$12.50.

Whoever sells like goods at different prices faces the possibility of being accused of discriminating in prices to the injury of competition. Such action may be in the form of a suit for damages or, more likely, a complaint by the Federal Trade Commission. Among the defenses against an allegation of price discrimination is "cost justification." Specifically, Section 2(a) of the Clayton Act as amended by the Robinson-Patman Act provides

"That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the different methods or quantities in which such commodities are to such purchasers sold or delivered."

Ever since the passage of the Robinson-Patman Act in June of 1936 antitrust attorneys, in government and in private practice, their accounting advisers, trial examiners, Federal Trade Commissioners, and judges have struggled over the meaning and application of these words. The source material on the subject consists of the records of contested antitrust cases where cost justification was pleaded in defense. For the most part these are dockets in Commission cases. There are also a few, very few, court cases where cost justification was an issue.

Professor Taggart has spent several years reviewing all of this material; indeed, he devoted to it his entire sabbatical leave and an additional academic year. He has made a painstaking analysis of each case, stating the cir-

cumstances which gave rise to it, describing fully and clearly the cost defense and the counterattack upon it, and offering freely his own comment on each accounting issue. The result is a comprehensive case book on the subject of Cost Justification; in fact, the only available digest and commentary on the litigated cases. It shows the mastery of a skilled analyst who has had a long and intimate acquaintance with both the theoretical and the practical aspects of his subject. Without doubt Professor Taggart's "Cost Justification" will be read and reread by everyone having an interest in this subject.

After reviewing the records in the individual contested cases the author summarizes his findings in two concluding chapters, "The Rules of the Game" and "Cost Justification: Where Does it Stand?" As an appendix there is a copy of the Report to the Federal Trade Commission by The Advisory Committee on Cost Justification.

OTTO F. TAYLOR, CPA
(Bacon, Taylor & Beairisto)
New York, N. Y.

ADVANCED ACCOUNTING PROBLEMS, THEORY AND PRACTICE

By Irving J. Chaykin and Max Zimering. JOHN WILEY & SONS, INC., New York, N. Y., 1958. Pages: ix + 562; \$10.50.

Although the authors have entitled their book "Advanced Accounting Problems, Theory and Practice," they have put considerable effort into their discussion of the underlying theory. This portion of the book will enlighten the student on each topic, and will help him in the solving of each problem. Chaykin and Zimering, in their

background discussion, have followed the latest recommendations of the committees of the American Institute of Certified Public Accountants on accounting principles and terminology. The language is lucid and will appeal to the student as well as the practitioner. Their background of 25 years teaching on the collegiate level has served them in a very good stead. The authors give a complete discussion in the particular area.

The authors state that the topics presented have been selected on the basis of their inherent importance in the field, and on the relative frequency of their occurrence on the CPA examinations. The topics appear to be well chosen, starting with preparation of financial statements, and going into partnership accounting (2 chapters), installment sales, statement of affairs, receivers accounts and statements, analysis of financial statements (2 chapters), agency and branch accounting, consolidated statements (3 chapters), fund accounting (3 chapters), cost accounting (3 chapters), and miscellaneous topics. It is difficult to take issue with the authors' choice, but the reviewer feels that perhaps fund accounting might have been shortened into two chapters and miscellaneous topics broadened.

This book can be an effective self-teaching medium, since it does a creditable job of trying to teach the subject as well as serve as a guide to the solution of similar problems. Yet, the book definitely can be used as a textbook in advanced accounting courses, since there is a workbook accompanying the text, which contains 118 pages of problems for the 20 chapters. The workbook also has 16 pages of fund accounting terminology in an appendix, which should be very useful to the student and to the practitioner whose knowledge of fund accounting has been inadequate.

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Alternate solutions to the problems are presented when the interpretation could call for another answer. Explanatory notes and comments are also furnished where necessary to supplement the answer to the problem, leading the reader through simple steps to the ultimate solution. The basic points in each problem seem to have been retained without undue length. The problems are cut down to their essentials.

Colleges would do well to consider the adoption of the text. The book can also be recommended as a reference work for the practitioner, as well as a review for the candidate preparing for the practice part of the CPA examination.

PHILIP WOLITZER, CPA
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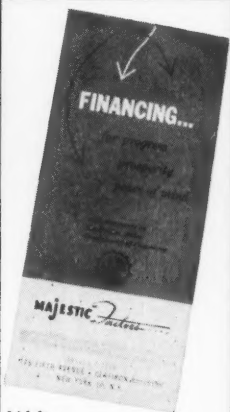
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INCOME GROWTH WITH SECURITY

By Sherman F. Feyler. THE MACMILLAN COMPANY, New York, N. Y., 1958. Pages: xi + 189; \$4.95.

Accountants will find this clearly written book interesting not only for its facile presentation of the operations and terminology of the stock market and its discussion of personal investment techniques, but also to become broadly conversant with clients' investing problems. To accountants serving organizations whose investments are extensive, such as nonprofit organizations, a familiarity with formula-plan financing apparently is desirable. The structure of such plans is the central subject of *Income Growth*.

The adoption of a formula plan minimizes the factor of timing in investing which makes it possible to devote almost undivided time to security analysis and selection. A cardinal element in any formula plan is its dependence on price movements rather than absolute price levels of securities. Direction of price movements is secondary to the degree of fluctuation of prices: Planned long-run preservation of total investment, income returns commensurate with risk propensities, and price movements, both up and down, combine in formula-plan financing.

Dividends of information about such things as dollar averaging, the Dow Theory, the NYSE Monthly Investment Plan, and investing philosophy in general make for a rounded discussion that is straightforward and well illustrated, cover to cover.

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**THE
PRESIDENT'S
PAGE**

The Need for Continuing Education

Few words carry more prestige among us today than the word "education." It is continually on our lips and in our hearts. We are sincere when we emphasize in our homes and in our business discussions the need for more and more education. But despite all this, one wonders sometimes how many of us relate this strong conviction to our own professional lives and actually do something about it. This message is a plea for continuing education at all levels of professional life. It is an attempt to put in focus some of the pressing reasons for this need.

We are all well aware of the great change in the accounting profession during this century and particularly during the last 20 to 30 years. It is not just numerical growth, although this has been tremendous. It is much more the ever-increasing variety of services being called for. In addition to audits leading to professional opinions on financial statements, there are demands for tax services, demands for all kinds of special investigations, and demands for a whole variety of work which comes under the broad heading of management services. Some of the work in this latter area is highly complex. There is a growing feeling that the profession is only now beginning to furnish the services that, in the future, will assume substantial proportions. It seems evident that the practicing accountant of today must be currently informed to keep pace with this rapid expansion in services.

Equally noteworthy is the great change in the educational level of accounting staffs. It would be interesting if we could make a comparison of the educational backgrounds of a cross section of accounting staffs as they

exist now with what they were, say, 25 years ago. We would undoubtedly find that men with college degrees were relatively few in the 1930s. This change in the educational level of the average staff man has created new problems. When an individual has spent 15 or 16 years in formal education, he is not apt to settle down to a humdrum existence with no clear future. He is unlikely to stay with a concern which is run by an individual or individuals who are not progressive and who do not inspire him to extraordinary performance and excellence. While we may not have a clear concept of motivation, we do know that it is unlikely to be found in any concern that is simply coasting along.

Our generation seems to be a generation of students and we should remember that the level of education and intelligence in our clients' organizations is also increasing continually. In addition to formal programs at schools and colleges and the continuing education which comes under the general heading of adult education, we find educational programs run by the military, training programs conducted by private industry, and university-run courses for business executives. One of the interesting developments in recent years is the series of university courses now available to junior and senior business executives, which concern themselves with the development of an executive's ability to think. These on-the-campus courses, which may extend anywhere from two weeks to several months, seek to show the executive new approaches to the solution of problems and to broaden his viewpoint and attitudes. When we think of these business executives as being our clients, it seems very clear that, as a group, they are becoming much more discerning. It is equally clear that if they do not get the up-to-date quality service they expect, they will inevitably go elsewhere.

The essence of this message is simply that education for the professional accountant is not just preparation for the future—acquiring knowledge and skill that will be useful later on. It is much more a continuous function unrelated to age and maturity. One of the very best things that can be said about any formal school program is that it produces graduates who are capable of further education and who will be continually aware of the possibilities of growth and the advantages that life's experiences offer. This is really why continuing education should be an integral part of the day-to-day life of the practicing accountant.

THOMAS G. HIGGINS,
President

An Inquiry into the Relationship of Law and Accounting

By JOHN W. QUEENAN, CPA

Law and accounting are closely related both in theory and in practice. By historical review and detailed technical illustrations this article expounds the broad philosophical principles underlying this relationship. Many examples are cited which illustrate opportunities for teamwork and which explain why the inevitable collaboration between the two professions has become routine.

THE formal relationship between the two professions of law and accounting, now extending into its second generation, was initiated to attempt to quell misunderstandings, and unfortunately the purpose incident to its birth has plagued its life a good part of the way. In fact to an outsider reading the volumes written over the years on this subject by members of the legal and accountancy professions, it might seem quite evident that we do not get along at all. Although we who are close to the scene do not in any way subscribe to this conclusion, we do recognize that it probably has been accepted by some. But we are not alone in this problem. Certainly headlines and stories about juvenile delinquency and the running

conflicts of nations have not given us a well-weighted picture of youth and man in their entirety. Perhaps the writers of articles on the finer achievements and inherent good of individuals have been triggered into their work by their reaction against the distorted proportional effect which "news" items sometimes unfortunately create. Perhaps by examining the negative aspects of the relationship between lawyers and certified public accountants, including the basic reason for them, I can demonstrate without a doubt that the over-all relationship of the two professions is essentially a very affirmative one.

OFFICIAL RELATIONSHIP— EARLY DEVELOPMENT

JOHN W. QUEENAN, CPA, is chairman of the American Institute of Certified Public Accountants' Committee on Relations with the Bar, chairman of the New York State Society of Certified Public Accountants' Committee on Cooperation with the Bar and co-chairman of the National Conference of Lawyers and Certified Public Accountants. Mr. Queenan is managing partner of the firm of Haskins & Sells, Certified Public Accountants.

A summation of the official relationship between the professional associations of lawyers and certified public accountants will show that, to a large extent, these relations have resulted from assumptions by some lawyers from time to time that certain services rendered by CPAs constitute an "unauthorized practice of law." Most of these difficulties have arisen in the

field of tax practice. The first formal meeting occurred in 1932, between spokesmen of the American Institute of Certified Public Accountants¹ and a representative of the American Bar Association, to discuss the proposal by the bar that only attorneys be permitted to practice before the Board of Tax Appeals. At that time, and from the inception of the Board, the lawyers and certified public accountants were admitted to practice before the Board by virtue of their professional status. In 1942 legislation was passed generally admitting lawyers without examination, while requiring certified public accountants and all others to pass a written examination.

The matter might seem academic in practice, since very few CPAs found it in their clients' best interests to try cases themselves before the Board. Rather, in nearly all instances, the cases were turned over to attorneys, who were in charge and who in most instances were assisted by the certified public accountants in the preparation of the accounting aspects of the cases, often as expert witnesses. But the right to file a petition with the Board, or its successor, the Tax Court, thus docketing the case, is often an important factor in administrative settlement in the Internal Revenue Service, and to CPAs the 1942 legislation seemed a step toward limiting their scope in a field which had always been open to them. In any event, the controversies which occurred during this 1932-1942 period, which included other aspects of tax practice in addition to the one just mentioned, demonstrated to the heads of both professions the advisability of settling differences between the two professions by friendly negotiation rather

than by litigation or legislation.

In 1944, therefore, to accomplish this purpose there was established by the American Bar Association and the American Institute of Certified Public Accountants the National Conference of Lawyers and Certified Public Accountants. The Conference consists of five lawyers and five certified public accountants appointed by the respective presidents of the national professional organizations. Each group is headed by a co-chairman, who presides at meetings of the Conference alternately with his opposite number.

In the first five years progress was slow. A number of incidents delayed an understanding as to how differences might be minimized, chief among which was the irritation provoked by two cases² relating to alleged unauthorized practice of law which local bar associations had brought into the courts.

A STATEMENT OF PRINCIPLES

In 1951, however, both the Institute and the American Bar Association approved a "Statement of Principles Relating to Practice in the Field of Federal Income Taxation" stressing the importance of voluntary cooperation between the members of the two professions in tax practice. This statement recognized that lawyers and CPAs were members of professions whose services are necessarily sought by business. It recognized that legal implications and accounting aspects of business problems are separate, but often so interrelated that they are difficult, if not impossible, to distinguish. The Statement recognized the rights both of lawyers and of CPAs to prepare Federal income tax returns, to practice before the Treasury Depart-

¹ Name changed from American Institute of Accountants in 1957.

² *Matter of New York County Lawyers Ass'n v. Bercu*, 273 App. Div. 524, 78 N.Y.S.2d 209 (1948), *aff'd*, 299 N.Y. 728, 87 N.E.2d 451 (1949); *Gardner v. Conway*, 234 Minn. 468, 48 N.W.2d 788, 40 Am. Fed. Tax. R. 245 (1951).

ment, and to render advice in Federal income tax matters. It stressed the common responsibility of the members of the two professions to recommend to their clients that the services of a member of the other profession be engaged when the circumstances clearly and reasonably called for knowledge and competence characteristic of the other profession.

In 1954, the three-year calm following the issuance of the Statement of Principles was disturbed. A court decision³ in California held that a certified public accountant was guilty of unauthorized practice of law in settling a tax difference with representatives of the Internal Revenue Service, although he was enrolled to practice before the Treasury Department and thus authorized by that department to do so.

This case emphasized to the leaders of both professions the harm and bitterness resulting from litigation. Meetings of the National Conference of Lawyers and CPAs were interrupted. However, during 1955 and 1956, particularly during the early months of 1955, committees of the American Institute of Certified Public Accountants and the American Bar Association met jointly to arrive at a sound basis for settling differences by friendly negotiation. By mid-1955 it was clear that disagreement as to the need for clarification of Treasury Department Circular 230 relating to practice before that Department was the principal stumbling block in the way of concurrence of views by the two committees. The committees presented their diverse views on this matter to the Under Secretary of the Treasury.

In January 1956 the Treasury Department issued a statement interpreting the pertinent section of Circular 230. This statement was a significant

milestone in furthering amicable settlement of interprofessional differences. In it the Department declared its intention to determine the proper scope of practice by its enrolled agents and stated that uniform interpretation and administration of the provisions of Circular 230 were essential. The Department also stated its intention that all persons enrolled to practice before it be permitted to represent fully their clients before the Department, and that there appeared to be no reason why the scope and type of practice should not continue as they had in the past.

In addition, the Treasury Department referred in an approving manner to the Statement of Principles and admonished the members of each profession to accept the responsibility of deciding when the other should be brought in, and said it would take appropriate action if enrolled agents and attorneys did not respect the field of competence of one another.

The Treasury statement removed some of the obstacles to negotiation which confronted the committees representing the two professions during 1955. During most of 1956 the Institute Committee on Relations with the Bar worked with Bar representatives on a joint report to the members of the parent bodies.

The substance of the joint report, issued in January 1957, was that the public interest as well as the interests of both professions, would be best served by expansion of voluntary machinery for self-discipline by the professions and by cooperation between them to enable differences between lawyers and CPAs as they may arise—whether in tax practice or elsewhere—to be resolved by conference and negotiation, rather than by litigation. It recommended that the National Con-

³ *Agran v. Shapiro*, 127 Cal. App. 2d 807, 273 P.2d 619, 46 Am. Fed. Tax R. 896 (1954).

ference of Lawyers and Certified Public Accountants, presently composed of members of the two committees, be reactivated to achieve these ends.

Further, the report affirmed the 1951 Statement of Principles as a guide to cooperation and not as a definition of the practice of law or of the practice of accounting. It suggested that the professions in each state consider the desirability of forming a joint committee similar to the National Conference. It encouraged local organizations of the two professions to refer disputes between members of the two professions to the joint committee at the state level, or to the National Conference. The committees cooperating in drafting the report foresaw that the resolution of specific cases would furnish a body of precedent to guide the members of their professions and, accordingly, recommended that the National Conference participate, at least for a time, in the consideration and settlement of disputes that are likely to serve as guides and precedents for other cases.

SEVERAL RECENT CONSIDERATIONS

During the past two years the attention of the National Conference has been directed to several specific problems. Early in 1957 the Board of Bar Commissioners of the Kentucky State Bar Association confirmed an opinion of its committee on Unauthorized Practice of Law declaring that preparation of income tax returns for compensation constitutes the practice of law, and requested the Kentucky Court of Appeals also to confirm the opinion. The consensus of the reactivated National Conference at its first meeting in February 1957 was that the action of the Kentucky Bar was contrary to the 1951 Statement of Principles and to the joint report. The Bar Association representatives on the National Conference undertook to deal

with this matter either by conference with the Kentucky Bar or by filing a statement with the Court of Appeals. Subsequently, the Kentucky Board withdrew its petition. Timely attention to this problem by the National Conference aided in avoiding what could have been another strained situation.

A matter of great concern to CPAs has been the Federal Administrative Practice Reorganization Bills (H. R. 3350 and S. 932), which were drafted by a special committee of the American Bar Association and introduced into Congress in 1957. These bills might severely restrict the position of non-lawyers in representing clients before administrative agencies. The American Institute of CPAs felt that it must oppose them, since they could well nullify the aforementioned statement of the Secretary of the Treasury interpreting Circular 230 and might well jeopardize the practice of certified public accountants in taxes as well as in other fields.

However, in 1958 discussions took place between representatives of the American Bar Association and the Institute which it is hoped will result in the elimination of the objections of the Institute before these bills are re-introduced in Congress.

The National Conference has discussed at some length the procedures to be followed by the Conference in dealing with threatened litigation. It had before it at one meeting certain information relating to a fee suit by a CPA in which attorneys for the defense had expressed an intention to raise the issue of unauthorized practice of law. This case, although not formally under consideration by the Conference, served as an example in considering procedures to be followed. This particular case was settled without going to trial.

DRAFT OF A CODE OF CONDUCT

There has been considerable discussion by members of the professions concerning lawyers and certified public accountants who practice in association and those who possess dual qualifications. A draft of a code of conduct, designed to provide a framework for cooperative action in this area, has been prepared; in its present stage, however, this draft must be regarded only as a working hypothesis requiring further study, discussion, and amendment in conference before a finished document can be produced, or, indeed, before agreement can be reached as to the substance of the document.

The code as tentatively drawn has three sections, the first dealing with accounting firms which employ lawyers, and vice versa, the second dealing with partnerships of lawyers and CPAs, and the third, with persons who themselves possess dual qualifications.

Briefly, the first section presently indicates that an accounting firm employing a lawyer and any lawyer so employed shall avoid any reference to the fact that such person holds a law degree, and that person may not continue to hold himself out as a practicing lawyer. Similarly, a law firm employing a certified public accountant or any CPA so employed shall avoid any reference to a degree which such person may hold signifying proficiency in accounting, and avoid indicating in any way that as a holder of a CPA certificate he is privileged to act as an accountant for clients of the law firm.

Partnerships between lawyers and CPAs are considered in the second section. Following the same principle expressed in the preceding section, it states that such a partnership may hold itself out either to practice law or to practice accounting, but not both, and that if the practice is law, the CPA

members should not identify themselves as CPAs in any way, and that if the practice is accounting, the lawyer members should not render legal services to clients of the partnership.

The third section, dealing with people who are dually qualified, covers an area in which there is a considerable divergence of opinion among the members of both professions. It is the feeling of many that the person qualified to practice either as a lawyer or a CPA may not serve in both capacities at the same time, but should choose to practice one profession but not the other, and should avoid signifying, in public or in communications with clients, that he is qualified to act in both capacities.

Many difficulties for both professions pervade these questions and they will require considerable study; the extent to which the proposed code might be helpful in overcoming them is being considered by the National Conference at the present time.

It is thus a fact that the first steps have been taken at the national level to set in motion the machinery of cooperation. It certainly seems that the two professions have created by their joint efforts a gateway to a new productive era in interprofessional cooperation.

To take full advantage of the opportunities, however, lawyers and certified public accountants of good will should try to understand the basic reasons for the differences that have arisen in the past. It seems to me that, conversely to my first thought, they have arisen from our common heritage. On second thought, this derivation seems clear.

RELATIONSHIP IN THEORY AND IN PRACTICE

Law and accounting are closely related both in theory and in practice. Law, the senior of the two, has been evolving its science from the early days

of man, when a solution was demanded for social conflicts. The science of law has as its foundation the general truths and principles of human conduct. It has classified the interrelated facts pertaining to this conduct in reference to these general bases and has embodied them in a system which can be broadly described as principles of law.

The principles of law inevitably had to deal with human conduct in the basic area of economics, the wealth-producing and wealth-consuming relations of all men. As principles of law evolved, basic principles of accounting, also in the area of economics, were growing at the same time, since of all the factors entering into the conduct and relations of men with one another, the money value of economic transactions has been one of the most significant. Accounting undertakes the classification and measurement of these values, and we find that the principles relating to it have been developed as occasion demonstrated the need by the Greeks, Romans, Germans, English and the other forefathers of our modern civilization.

As enterprise has grown, law and accounting have kept pace with it. When trade and industry were conducted on a local basis, mostly as personal ventures, accounting was simple, and legal problems involving measurement of values were not difficult. The development of joint ventures and partnerships, followed closely by the corporate form of business management, with their multiple absentee ownership and, more recently, with governmental taxation of their income, have made business as such a matter of wide social importance. Accounting, as the language of business, has become influential from the viewpoint of public policy, and like the forms of business it serves, more complicated.

Accountants came into being as the

specialists required to classify, summarize, and interpret the effects of the many difficult operations and transactions of business organizations. As they increased in numbers they began to take to themselves the development of their own branch of science—the cornerstone of which is double-entry bookkeeping, the theory of accounts. Here we find the accountant's knowledge of the action of both economic forces and accepted legal rules, squared and leveled into a systematic arrangement. From these basic propositions the rules covering the many unusual situations which seem to arise continually in our complex business system can be deduced, on a syllogistic basis. Just as a lawyer in the process of litigation proves his minor premise in relation to a proposition of law, so the accountant, following similar deductive processes, establishes his minor premise by relating it to broad accounting principles.

ILLUSTRATION OF CLOSE ASSOCIATION

The close association between law and accounting can be illustrated easily. Some years ago there were decided differences of opinion between lawyers and accountants in areas such as the presentation of treasury stock in financial statements, as discussed in the next paragraph, and as to whether capital surplus, rather than earned surplus, should be charged with certain dividends and losses. Certain differences still exist, particularly in the so-called "regulated companies." These differences in opinion are understandable, for the training and professional background, though often similar, were not the same, and because too, the individuals who made up each of the professions failed in some instances to think through to the views of the other. Lawyers have written the statutory law. Until it is changed this law must dominate the court cases in which

it is applicable, even where in its treatment of accounting matters it conflicts with what accountants have come to look upon as "accepted accounting principles." But it is only through the slow growth of these "accepted principles" that accounting has been able to meet the needs of our expanding economy. It is to that body of principles, resembling common law, that accountants have traditionally turned as authority.

Accounting terminology is not an exact medium of expression; it is not a chemical formula. Take, for instance, the once widely debated dispute between accountants and lawyers regarding the presentation of treasury stock in financial statements. The laws of most of our states prohibit a corporation from buying its stock for general treasury purposes, which may include purchases in anticipation of later retirement, if such purchase results in impairment of its stated capital. In other words, such purchase must be made out of surplus. From the legal point of view, therefore, many lawyers contended that in a balance sheet treasury stock should be deducted from surplus, to indicate clearly the appropriation which has been effected by the purchase of the shares. Accountants did not argue with the position that treasury stock does not itself reduce legal capital. But many of them believed that the balance sheet was presented more clearly if the treasury stock were deducted from the stock issued, after adjustment to par or stated value, and a statement was made, parenthetically or otherwise, that the surplus is restricted to the extent of the cost of the treasury stock. The accountants based their thinking on the fact that in many cases treasury stock would not be reissued. The holders of the outstanding shares have a proprietary interest in the equity of the corporation,

including accumulated earnings and other amounts in excess of capital; it was felt by many accountants that deduction of treasury stock from surplus beclouded this point of view. The logic behind both positions is clear. A compromise commonly used today is to deduct the treasury stock, at cost, from the total of the capital stock and surplus, with an accompanying statement regarding the restriction of the latter. This obviates the difficulty of allocating the cost to any particular kind of surplus and also overcomes the objection to an indicated reduction of the capital stock.

In some cases of apparent differences, as just described, both the lawyer and the accountant may be right. Who is the more nearly right is not the really important thing. The accountant must fit his statement form to the situation, once he has mastered not only the legal precepts, as interpreted for him by lawyers, but also the matter of expressing the facts in practical accounting terminology, as he and other accountants understand it. As indicated in the preceding paragraph, appreciable strides have been made in recent years by both lawyers and accountants in reaching a meeting of minds with respect to the latitudes possible in the use of accountancy terminology once they are in agreement as to the facts and the law involved.

COMPLEX PROFESSIONAL CHARACTER OF CPA SERVICES

As we know, accountants perform many tasks. Most accountants are employed by business enterprises, and in such capacities are directly responsible to their employers. In this role they perform the important duty of furnishing accounting information to the managers of the affairs of business.

Practicing certified public accountants, on the other hand, provide serv-

ices to different organizations or clients. Each state, territory, and the District of Columbia grants the designation "certified public accountant" (CPA) on the basis of a uniform written examination, but with varying practical experience and education requirements. The principal service rendered by many certified public accountants, commonly referred to as "auditing," includes the examination of financial statements and the reporting of an independent opinion concerning the fairness of the statements in presenting financial condition and operating results of an enterprise.

It may be interesting to take a closer look at auditing. It is essentially a corroborative process. No attempt is made to duplicate the work of company employees who have recorded the day-to-day transactions, or to verify the accuracy of every transaction. Each examination—assuming of course that the accountant has been authorized by his client to perform the necessary work—is sufficient in scope to enable the CPA to render an opinion, and is conducted in accordance with generally accepted auditing standards. These impose no restriction on the exercise of sound judgment, however, and imaginative, clear-thinking accountants can judge the fairness of financial statements, or determine what adjustments or additional disclosure may be required, through a minimum of procedures especially designed to fit the circumstances of each engagement.

Throughout an audit the CPA is concerned with all matters that have an important bearing on the company's financial condition and operating results, such as whether certain stated physical assets actually exist and liabilities have been properly determined and disclosed; whether income has been properly accounted for and appropriate provisions have been made

out of income for costs, expenses, taxes, and losses. He must consider whether accounting principles have been followed that are appropriate in the situation and whether they have been applied in a consistent manner so that a meaningful comparison can be made with the statements for other periods.

At the outset of a typical audit the CPA studies the financial statements for indications of unusual accounting or auditing problems and for signs of important changes or trends in the business. He reads minutes of the meetings of stockholders, directors, and major committees to note discussions of important happenings and adoption of significant resolutions.

The initial review is helpful in determining the areas needing special attention and in outlining a general program for the audit. The extent to which various audit tests are applied, however, depends upon the CPA's judgment of the company's internal control and accounting system—whether its accounting procedures and the arrangement of duties within its organization lend weight to the reliability of the accounting records and provide adequate safeguards over the company's assets.

He studies the company's accounting system and procedures and observes how members of its accounting staff carry out their various functions, discusses with them the nature of their records and duties, and reviews their work on a sampling basis for selected periods. This means inspecting such source documents as suppliers' invoices, paid checks, payroll and production reports, and the other original records. In this way he evaluates the effectiveness of the system in recording the transactions in the books.

These initial tests may lead to a conclusion that the system effectively minimizes the possibilities of error or mis-

representation, in which event the tests of documents and records may be limited to no more than a relatively small portion of the transactions. In many companies, however, there are at least some aspects in which the system is not entirely effective, and in the case of smaller companies, the size of the business often precludes arrangements of duties that would be economical in operation and at the same time would provide satisfactory internal control. In these situations more extensive tests will be required than would have sufficed if there were effective internal control.

The CPA supplements the tests of underlying records by studying the composition of balances in the accounts and by obtaining outside evidence. Thus he gains further assurance of the reasonableness of the amount, description, and classification of the items in the financial statements.

Authorized communication with the company's customers, creditors, and banks regarding the status of their transactions may reveal discrepancies requiring explanation and reconciliation. Actual count of assets such as securities and cash establish whether the amounts shown in the accounts are in fact on hand.

It is frequently necessary to consult with the company's attorneys in order to gain a clear understanding of a legal matter. It has become a routine procedure for the auditor to communicate with company counsel to inquire as to the existence or status of any direct or contingent liabilities of the company. The company in its footnotes to its financial statements disclosing litigation usually gives the opinion of counsel regarding the merit of a claim or its possible materiality in relation to the company as a whole. Personal contact between the auditor and the attorney in matters of this nature is generally much more satisfactory than

handling them by correspondence alone.

No part of this over-all review phase of an examination can be regarded as perfunctory, even though some normal and customary auditing procedures are performed. The accountant is confronted with a real challenge of ingenuity, and with an inquiring mind can discover many sources of information bearing upon the credibility of the accounts.

In practice, the steps described above are integral parts of the whole audit process. One of the most notable and important examples of this principle is to be found in the examination of inventories. Tests of purchase, production, and sales records can establish tentatively the adequacy of the client's accounting system for recording the various activities that affect the final inventory balance. The CPA can be reasonably satisfied concerning the final balance, however, only through additional procedures that will include, for example, ascertaining the existence of the inventory, considering its condition, and determining the weight to be given where appropriate to original costs and to current market prices.

To obtain such independent evidence, after reviewing the company's instructions for inventory-taking, the CPA actually observes employees taking the inventories. He counts selected items and compares his counts with the inventory tags. He also talks with foremen and other shop employees as to the condition, usefulness, and description of the stock, and may later discuss its saleability with representatives of the sales department. The mathematical compilations and computations are also tested.

He satisfies himself that in the inventory-counting there has been a proper cut-off for receipt and shipment of goods. This is done by referring to receiving and shipping records and

through discussions with employees responsible for those records. Then he examines the general records to ascertain whether there has been a similar cut-off in recording materials purchased and products sold.

The foregoing are just a few examples. They point up, however, that the CPA's opinion of the valuation the company has placed on the inventory is based on far more than examining records. It is based importantly upon analysis, independent evidence, observation, and discussion with the company's employees.

These procedures, though explained in relation to an examination of inventories, illustrate the whole approach to auditing. Perhaps the most important aspects of auditing are the weighing of information or evidence obtained through one procedure against related information obtained through another, sensing the existence of a proper relationship, and recognizing where disproportion may exist. This is a process of reconciling situations and amounts apparently at variance with each other, where any lack of normal correlation may be a clue to some troublesome area in the accounts. Correlating information obtained by systematic inquiry, or even informally, and appraising its significance in relation to observed facts, may reveal inconsistencies requiring investigation. Thus the CPA appraises both the quality and quantity of the evidence before him to distinguish the significant from the immaterial.

Before rendering his report at the conclusion of an audit, he reviews the financial statements with the company's executive officials, especially as to clarity and adequacy of disclosure. He discusses with them the implications of significant data, and advises them as to form and content of the statements.

The adoption of effective measures

of internal control greatly lessens the opportunities to perpetrate and conceal a fraud for any who may be so minded. While it is, of course, a responsibility of a company's management to provide adequate safeguards over its assets, the auditor can render a valuable service through suggestions for strengthening internal control.

It is my hope that this rather extensive treatment of some of the intricacies of auditing has demonstrated that effective execution of that work demands not only intensive thought and alertness, but also judgment and keen imagination.

ACCOUNTING PRINCIPLES AND LEGAL PRINCIPLES

The professions of law and accountancy serve, by and large, the same clients—all the elements that make up a complex industrial society: the individual, the corporation, organizations, institutions, and governmental agencies. It does not seem surprising at all to me that, as happens in all families, there have been disagreements. Perhaps the amazing thing is that there have been so few. Certainly, an insignificant percentage of difficulties should not blind us to a general picture of harmonious collaboration. Let us consider the backdrop, and then a few specific instances, of this latter relationship.

Lawyers are primarily concerned with the orderly and equitable relationships which must obtain among the many elements of our society if it is to function. Their task is to protect the rights of their clients as those elements accommodate themselves and their activities to a social order where the rules of conduct and trade are prescribed by law.

The certified public accountant finds that he, too, is a servant of order. For while the law makes possible the ownership and transfer of property, ac-

countancy helps to make property manageable and negotiable. This it does by providing intelligent information for the fiscal management of property and by providing standards for reporting on the accountability of management.

It is a large part of the business of the certified public accountant to render intelligible reports fairly representing what is going on. This is not simply a matter of bookkeeping, of adding up the money received and the money spent and then finding the difference. Although monetary units are an important part of the language of accounting, they are only a part. The function of the certified public accountant is to interpret financial events based on facts to the extent possible, but, of necessity, based on judgment in many instances. The pattern of reporting must reveal, usually in circumstances of great and far-reaching complexity, a record of business operations, fairly determined, in a changing and rapidly progressing society.

The certified public accountant cannot avoid judgments on matters which present perplexing questions of principles, such as basic assumptions as to objectives and useful end results of financial reports. Indeed, it is only from the consistent application of such principles that an intelligible report of financial progress can emerge.

But even accounting principles are subject to change, as is the common law. In a society as dynamic as ours, the very concept of our institutions changes, and the relationships that exist among them shift in balance. Thus, while accountancy, like the law, looks to principle for the blueprint of order, it finds that accounting principles, like the law, are not constant, but are changing to accommodate new customs and new ideas of what is right, proper, and desirable. And the developing habits, customs and practices

of today become the substance of the laws of tomorrow.

COLLABORATION BETWEEN THE PROFESSIONS

Serving the same clients, in closely related disciplines, it is inevitable that law and accounting work side by side. Lawyers and certified public accountants are thrown together day after day in all parts of this country. Each brings the competence of his discipline to bear directly upon the problems of a client, the demands of whose business with growing frequency require the aid of both professions. Collaboration between the two professions has become routine.

Now much of this collaboration has come about, I suppose, from the increasing involvement of government, directly and indirectly, in the affairs of our clients. We are subject to tax laws, to securities exchange regulations, to rate regulations in some industries, to new legislation under the interstate commerce clause, and to new interpretations of old legislation. All such things introduce matters of law, matters affecting management practice, and matters of financial reporting. And in all these areas, and many others, we find certified public accountants and lawyers working shoulder to shoulder in an attempt to arrive at wise judgment and action. It is teamwork between two respected and accredited professions.

In no area have the attorney and the accountant worked in such close unison as in their joint efforts in preparing clients' data for presentation to the Securities and Exchange Commission. Another area of close collaboration is that of tax practice. Many individuals have made efforts to draw an exact line of demarcation, the one side representing the province of the legal profession and the other that of the certified public accountant. After dec-

ades of attempts, it is quite apparent that exact line-drawing of this kind leads only to disagreements. In a case some years ago a jurist in his opinion stated, "the line which divides the domain of the lawyer from that of the accountant . . . is often shadowy and wavering. . . ."⁴ In my experience with attorneys there have been no lines. Each practitioner has respected the other for his qualifications, thus permitting and encouraging maximum participation by both.

AN EXAMPLE OF TEAMWORK

I should like to cite a specific example of the type of teamwork which is essential in a great number of tax cases if they are to be handled properly.

Several stockholding executives of a closely held corporation made gifts of corporation stock either direct to or in trust for members of their families. A number of years later upon review of the gift tax returns, the examining agent of the Treasury Department questioned two matters. In the first place, he felt that the language of the trust agreements made the stock transfers gifts of future interest rather than outright gifts, as a result of which the donors could not benefit from the annual exclusion deduction which had been taken in the returns as filed. Secondly, he felt that the value assigned to the closely held stock was too low. It is pertinent to note that at the time the gifts were made the donors received limited advice of either a legal or accounting nature.

The executives as a group called in a representative of the firm of attorneys which was acting as counsel for the company, and asked him to deal with the examining agent. When he discovered that the facts included a matter of valuation of the company's

stock, the attorney obtained permission from his clients to bring into the case a representative of my firm, which had been acting as auditors for the company for many years.

It was decided that our firm would prepare a report setting forth certain information relevant to the fair market value of the stock at the gift date. We first approached the matter from an income standpoint, and decided to use the "price times earnings ratio" of comparable companies in the industry whose stock was listed on exchanges. We were in constant touch with the attorney in this regard, particularly in reaching an agreement with him that the companies selected were of a truly comparable nature. After we had agreed on the companies to be used, a tentative valuation was reached. Stockholders' equity per share was next computed. Statistical conclusions were developed from subsequent public offerings, after long discussions between the attorney and ourselves, and the basic computations referred to above adjusted accordingly. The poor dividend record of the company was next depicted, along with the industry outlook at the time of the gift, as recorded in industry surveys and in national periodicals. In this latter area we both searched far and wide for pertinent detail, and this section of our report in particular was a joint effort, since in conversation with company officials the attorney had unearthed the fact that an industrial engineering company had made a detailed report on the future of the company just two months prior to the date of the gift. This report was invaluable in establishing the conservative atmosphere which had existed at the gift date, an atmosphere, incidentally, which was hard to recapture in view of the financial success enjoyed by the company

⁴ *Blair v. Motor Carriers Service Bureau*, No. 4863, Penn. Court of Common Pleas No. 6, June 1938.

in the period following the gift date.

In our report we computed a valuation based upon the procedures just described. We concluded with the thought that a valuation less than the one we had computed was in order. We stated that we were not in a position to state categorically that the value used in the gift tax return was an exact value as of that date, since it was difficult for us to evaluate the amount of deduction (for poor dividend record, industry outlook, etc.) which should be made. On the other hand, without the benefit of hindsight, we felt it would be equally difficult for us to disprove the value which was made by persons entirely familiar with the company's operations, prospects, and economic status at the date of the gift. Prior to the final preparation of our report, the final draft was reviewed by the attorney and his suggestions incorporated therein.

By this time the attorney had concluded that the trust instruments were improperly drawn from a gift tax standpoint; he prepared new agreements which eliminated the "future interest" aspect and which would qualify any gifts made thereafter for the annual exclusion benefit. The attorney's next task was to write a letter to the District Director of Internal Revenue, conceding the trust issue but standing firm on the valuation matter, and enclosing a copy of our report as supporting evidence. His letter further supported the position taken in our report that the computed values must be discounted, chiefly by furnishing numerous case citations based on companies with poor dividend-paying records. This letter was revised three or four times, each draft being submitted to us for review and for consideration of possibly desirable changes.

The final result, following a full-day meeting attended by the examining agent and the legal and accounting

representatives, was an acceptance of the valuation used in the return. I have recounted the recent case in some detail, since its facts are still clear in my mind. It paints a picture which occurs now with regularity, the tempo of which is perhaps even increasing as the evolution of accounting as a service and as a profession has demonstrated that it is soundly equipped and sufficiently disciplined to work together with the legal profession in a constructive manner. Equally important to both professions, it seems to me, is that the public interest has required such professional collaboration.

LEGAL INTERPRETATION AND AUDITING

Another instance of the need for legal interpretation by the accountant in auditing work itself occurred recently in the examination of the financial statements of a company and its predecessor proprietorship whose principal assets were notes receivable. These notes, due generally in forty-eight monthly instalments from purchasers of the company's construction-type product, were usually discounted with recourse with banks or factors shortly after receipt, in order to provide needed working capital. The banks and factors withheld as collateral a reserve of approximately twenty percent of the face value of the notes receivable, as well as the conditional sales contract covering the product.

At the inception of the corporation, the predecessor proprietor transferred to the company certain assets, including notes receivable and amounts held in reserve by banks or factors. We asked counsel for the company and the lenders for opinions as to passing of title and the status of concomitant liabilities. Briefly, the replies stated that the assignment by the proprietorship did vest title legally in the company, and that although there existed

for the proprietorship a contingent liability over and above the value of the assets transferred, no such contingent liability passed on to the company. This question was of crucial importance in presenting the financial position of the company and the attorneys' answers provided the key.

In the preparation of instruments such as bond or loan indentures, profit-sharing plans, or agreements governing sale and purchase of assets or a business, it is quite usual now that the lawyers drawing up the document consult the accountant while it is in draft form. As an example, many bond indentures include provisions which limit the payment of dividends, usually in relation to the net earnings of the company. It has been most satisfying to accountants as a group to see that with increasing regularity "net earnings" is being defined in indentures in words such as "net income after Federal and other income taxes computed in accordance with generally accepted accounting principles." This enables the company to use for such purpose the net income amount it has reported to its stockholders. The simplicity and satisfaction resulting from this approach is in sharp contrast with some situations I recall in my early days in auditing when unsuccessful attempts to define in detail in a note agreement the method of computing earnings sometimes left open a question as vital as whether the term was intended to mean earnings before income taxes or earnings after taxes. The increasing cooperation of lawyers and accountants in matters of this nature is not surprising, for it is only prudent to ascertain that the accounting terms used are defined meaningfully to the person who will prepare the financial statements to which the terms will be applied.

LEGISLATION AND ACCOUNTING MATTERS

Similarly, drafts of laws which include accounting provisions should be reviewed with accountants. In 1909 President Taft, with little warning, presented to Congress a proposal for a corporation tax based on income. Within a matter of days a circular letter signed by twelve New York City accounting firms was sent to each member of Congress.⁵ It pointed out that some of the bill's provisions were absolutely impossible of application and that others violated all accepted principles of sound accounting. History records that ultimately the accountants were heard and that in many respects their advice was followed.

This is a far cry from the present era, when Congressional committees make it a point to invite accounting organizations such as the American Institute of Certified Public Accountants to submit in advance their views regarding proposed laws affecting taxation and other accounting matters.

Along with other members of the Institute's Committee on Accounting Procedure, it was my pleasure some years ago to be invited by representatives of the American Bar Association who were working on the draft of a Uniform Corporation Act to meet with them to review relevant accounting aspects. I vividly recall that we spent considerable time in vigorous and stimulating sessions covering a wide range of accounting subjects, and that at the meeting's completion there was an agreement that not only had the accountants learned a great deal about the problems of writing a law, but, to the main point, the lawyers, who were enabled to include in their draft terminology a discussion of accounting matters in definitive form, felt that the

⁵ 8 J. OF ACCOUNTANCY 212.

language of the proposed legislation was definitely improved.

COOPERATION ON THE LOCAL LEVEL

Although the national pattern in this respect is encouraging, the picture is frequently not so assuring at the local level. In my opinion, lawyers who draft at all levels statutes or administrative regulations which include accounting provisions or references would be well advised to consult with representatives of the accounting profession. I believe such lawyers would find accountants as a group very willing to cooperate, and that the time so occupied would be very well invested.

In bankruptcy proceedings, accountants usually prepare the financial statements as of the date of filing a petition. They also may be called in by an attorney representing a creditor to examine the books and records of the bankrupt to search for preferences, prior siphoning off of assets, or some questionable transaction which might be a bar to a discharge in bankruptcy.

In suits involving accounting matters many attorneys have an accountant sit in to analyze the testimony given on behalf of the adverse party. I have heard attorneys who follow this practice say that it is difficult enough to try a case without having to analyze technical data, even in those instances where it is understood. In other instances, I understand, the Court has had an accountant summarize accounting testimony for the benefit of a jury.

In incorporations, mergers, dissolutions, and reorganizations, lawyers and accountants have become so accustomed to working together that a separate approach to a matter in this area would be rather unusual and perhaps dangerous. It has been quite commonplace to read advertisements of financial institutions stating that estate work is not the task of one, but the teamwork of a lawyer, accountant, insur-

ance adviser, and the bank trust officers. These are instances of placing the interest of the common client in the forefront.

To these few examples could be added, if space permitted, literally hundreds of different type situations where collaboration has resulted in a better over-all type of service being rendered.

Recently members of a local bar association and a society of certified public accountants met together in a combined session initiated by officers of the legal group. Accountants spoke on matters relating to business and professional net income; attorneys talked about topics such as estate planning, taxable deductions, inter vivos transfers, wills, and joint tenancies. Each participant discussed his subject fully, the attorneys from the legal point of view and the accountants from the accounting viewpoint. In the discussion period which followed, the accountants referred to the lawyers on legal matters and the attorneys submitted matters of accounting principles to the accountants. There was displayed a genuine air of mutual respect and confidence which spelled out the recognition by each group of the teamwork which is often required in the common goal of serving the public.

CONCLUSION

This is the atmosphere which I have found over the years in my work as a certified public accountant. That work has kept me in almost continual contact with my friends in the legal profession, a rewarding circumstance which has resulted in some of my finest personal associations. It recalls to me the story I heard many years ago of the three masons who were asked what they were doing. The first said that he was working for ten dollars a day. The second individual replied that he was cutting stone. The

last of the three said simply that he was building a cathedral. This last answer can bring only admiration from us all, for it displays in the individual a fierce pride in the work he was doing. It would be well for all of us, lawyers and accountants alike, to emulate this attitude to the extent we are able, for out of our exertions we may expect that something worthwhile, large or small, will be added to the

grand total of man's achievements. In my judgment, we will be able to contribute personally and professionally much more truly and directly by continuing our efforts, which have been very successful in the past, toward the common goal of a strong and affirmative relationship between our professions. Assuredly these ends are in the best interests of our clients and of society as a whole.

TRAINING AND EDUCATION FOR ACCOUNTANTS

In the eyes of the business community the distinguishing role of the chartered accountant is that of auditor. In the growing complexity of the national economy the role of auditor is becoming no less important and no easier to fulfil. The accounting profession must hold its standards of training for this role, and yet, as it comes to accept growing responsibilities in the fields of management, auditors more than ever before should be broadly-educated men with open minds and some appreciation of the diverse types of ability and judgment required of the executive.

If professional requirements are to be no less stringent than in the past along the lines of auditing skills, where is this further education to be fitted in and how will it be provided? In the long run the universities will come to regard management as a learned profession and will offer more courses in management orientation at both undergraduate and post-graduate levels. Even before this time arrives, accounting in its more philosophical aspects will be recognized as a true liberal arts subject, on a par with mathematics and economics. Many liberal arts students who take a course in accounting as an intellectual exercise will acquire a taste for more. Upon graduation they will become students of the profession, with the added advantage over today's arts graduates of having a head start in the professional courses.

From an editorial in
THE CANADIAN CHARTERED ACCOUNTANT, May 1959

Motor Hotels and Market Studies- The Accountant's Role

By JOHN D. LESURE, CPA

The accountant can and should play an important part in the market study and analysis preliminary to the entry of his client in the motel industry. Research, technical and legal advice, and sound tax planning properly integrated and evaluated by the CPA can make such entry easier and economically sound. The procedures undertaken in the conduct of such a study are discussed in this article.

BEFORE proceeding with the discussion of the accountant's role in the acquisition of motels and motor hotels, it appears advisable that we define the terms "motel" and "motor hotel." The reader is undoubtedly familiar with the so-called tourist or motor courts which have been with us for some 25 years. The typical cluster of small cabins surrounding a driveway and an office can be seen on most of the secondary roads and older highways in this country. The term "motel" began to have wide usage when those cabins were combined in one structure, the facilities were expanded and the style of operation and furnishings was upgraded. The next step which marked the dif-

ference between a motel and a motor hotel, was the addition to the motel operation of some hotel services and facilities, particularly restaurant and bar facilities. Many other conveniences, such as 24-hour telephone service and room service, are now offered by the modern motor hotel. Size is not a determining factor in the definition since it is not unusual to find motels of 100 units or more, and motor hotels with as few as 50 units. It is rather in the facilities available and the services and conveniences offered to guests that the motor hotel differs from the motel or tourist court.

THE CPA'S INTRODUCTION TO THE MOTEL INDUSTRY

Very often, an accountant does his first work in the motel or motor hotel field in behalf of a client who previously was active in an entirely different industry. The client may have been offered an opportunity to invest in a motel property, or he may have become enthusiastic about the possibilities of "retiring" and operating a motel. On the other hand, a client in the

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hotel or restaurant field may have come to his accountant for information concerning the opportunities in motel operations.

It is necessary to divide clients interested in the motel or motor hotel field into two categories, the "amateur" and the "professional." Normally the amateur has no true knowledge or concept of motel or motor hotel operating problems, and he has usually been oversold on the profits to be derived from motel operations. The professional, who may be actively engaged in either the hotel or motel field, is also in need of much information. He may not be aware of the differences between hotels and motels, or motor hotels, or he may wish to expand his present operations without a proper appraisal of the potentials of the location.

DUTY TO THE CLIENT

The accountant must be prepared to explain and evaluate the ways by which a motel may be acquired; he should recommend the best sources of professional advice, and he should foresee some of the many problems which would confront somebody new in the field. He should certainly be prepared to either undertake a study himself or recommend that somebody else conduct a complete study of a proposed venture or an existing operation. This is stressed because there are three basic trends helping to determine the success or failure of a motel or motor hotel venture today:

1. The rapidly expanding and shifting pattern of arterial highways.
2. The steadily climbing cost of construction.
3. The ever-present threat of overbuilding in the industry.

WAYS TO ACQUIRE

The client interested in acquiring a motel property may build one, lease

an existing or proposed venture or buy an existing operation. He may also combine the possible courses of action to a certain extent and build on leased land or buy an existing leasehold. In addition, many owners of motor hotels lease out the restaurant operations to persons more experienced in that specialized field. The sale-and-lease-back arrangements, now very popular in real estate circles, are becoming prevalent in the motel and motor hotel fields.

BUILDING A MOTEL

Let us assume that a client desires to build a motel or a motor hotel. As his financial advisor, it would be well for the accountant to point out the advantages of leasing a site so that the initial investment could be made in construction and furnishings rather than in land. Particularly in urban centers, the cost of choice locations is often prohibitive to any but the largest motel or motor hotel operators because so large an area is required for parking. It is generally recommended that at least one parking space for each unit and one parking space for each five restaurant seats be provided. After making additional allowances for employee parking and service areas, a 60-unit motor hotel can easily require nearly two acres of parking and driveways.

It is sometimes possible to pick up good sites by paying up tax liens on the property, particularly in rural areas. Later in this article we will stress the need for sound legal advice in connection with acquisitions such as the type just mentioned.

A good location is of primary importance to the prospective motel investor. If possible, a site near the intersection of two major roads should be chosen. Ready access to either of the two highways and good visibility in either direction would be important. Nearness to an urban center or to some

physical feature that requires or encourages motorists to stop, is also a definite advantage. It is imperative that the client have some idea of, or be apprised of, the value of knowing ahead of time the type of traveler to which he will cater. The purpose behind the traveler's visit to the area determines to some extent the type of accommodations that he will demand and the style of operation that your client must provide. All of these factors and many more enter into the determination of a good location.

Once location and style of operation have been decided, it becomes advisable to engage an architect to prepare preliminary plans and, finally, working drawings. Contractors bid on the basis of the working drawings, and the contractor presenting the best bid for the quality of work desired is engaged. It is normal procedure to require posting of a bond to insure completion of the work, and usually a time limit is stipulated in the final contract. Once again, the obtaining of expert legal advice is necessary.

Normally, contractors will present a fixed-price bid, estimating their costs and including profit. Sometimes a cost-plus bid is made; that is, the contractor agrees to build for cost of materials plus a fixed amount. This is a dangerous type of contract for the inexperienced builder who does not have sufficient knowledge to accurately appraise the work of the sub-contractors and the quality of the materials. The work must be supervised constantly and attentively by the client or his representative if full value is to be received.

In furnishing the completed motel it is good policy to seek professional advice. Investment can be kept to a minimum by purchasing from one of the several suppliers that finance purchases of hotel, motel and motor hotel furniture. However, the client should be aware of any additions to the cost

of the equipment as a result of the financing charges.

The client should also be impressed with the importance of determining in advance the amount of working capital required for the preopening period and the first few months of operation. Once the motel is built, it becomes necessary to engage employees and prepare for the first customers. Actually some key employees should be hired prior to the completion of the building so that the opening can be properly scheduled. Then too, it is not likely that the project will realize the full potential of its market immediately and continuously right after opening. The client should be apprised of the necessity for having adequate funds available to cover operating costs until the new venture becomes well known and can begin to show profits.

LEASING

If the client is not interested in building a motel or motor hotel, or does not have the necessary funds, it would be well to advise him to lease an existing operation. Usually, a year's rental in advance and some sort of security deposit are required in order to lease, but the aggregate would probably not exceed 20 per cent of the investment necessary in order to build. The property should be carefully studied, of course, before any commitment is made.

In general, there are two types of leases, one calling for a flat or fixed rental, and the other for a percentage rental. Each has its advantages and disadvantages, and the choice depends mainly upon the relationship between owner and operator. In a fixed-rental situation, the owner assumes no risk and is completely freed of association with the venture. The operator, of course, receives all profits above the fixed amount and thereby benefits directly and entirely from his own efforts.

On the other hand, the percentage rental tends to spread the risk and benefits in that the owner shares directly in an increase in profits in a good season but has his income from the operation cut in the event of a poor season. A minimum fixed annual rental is generally a requirement of the percentage lease.

Owners normally require a "net lease," that is, the operator is responsible for real estate taxes and fire insurance in addition to the fixed or percentage rental. It is advisable to study very carefully the tax structure of the area and to attempt to foresee the extent of population growth that may arise. Taxes on residential housing alone are not adequate to cover municipal costs, and the tax rates in residential communities have climbed rapidly in recent years. An area where substantial future industrial growth is likely to occur is usually a safe location from the standpoint of stable property tax rates.

The duration of the lease is an important factor to consider. A short-term lease (10 to 15 years) can be entirely unsatisfactory to an operator. Usually it is a sufficient length of time for the owner to recover his investment but not enough time for the lessee to have the opportunity to benefit from the building-up period.

The best years of a motel may be few in number because of obsolescence, changes in travel habits or patterns, and the construction of new competing operations. A long-term lease of 25 or more years may therefore be equally unwise. Experience has shown that a lease of 15-20 years duration, with a renewal option at a lower annual rental, is to the best interests of both owner and operator of a motel property. However, each motel project should be analyzed individually before attempting to determine the best type of lease.

In preparing the lease it would be well to consider several points in addition to those just mentioned. Again, it is important to stress the role of the attorney as well as that of the accountant. If it is an existing operation, the care and replacement of furniture and fixtures should be covered. Normal wear-and-tear must be recognized by the owner as a factor, and he cannot expect the lessee to return the property to him in precisely the same condition as it was at the time the lease began. A physical inventory of existing equipment should be provided by the owner and checked by the lessee. Provisions for sharing the cost of rehabilitation or repairs to the building, particularly the exterior, should be included. The lessee should be protected in the event the property is sold, and he should also request a clause in the lease providing for sub-leasing in the event he cannot complete the term of the lease. There are numerous standard lease clauses and special provisions such as those covering examination of records, insurance, style of operation and unrestricted use of property for which competent legal advice is required.

OBTAINING PROFESSIONAL ADVICE

I have already frequently mentioned the importance of having an attorney advise your client. Now I would like to mention some of the other sources of professional advice that are available to your client.

In considering the purchase, leasing, or construction of properties, it is necessary to seek the advice of a competent architect. The American Institute of Architects will provide the names of experienced men in the area. There are many consultants who specialize in layout and design, interior decorating, market studies and the preparation of projections of income and expenses for motels and motor hotels. These people are usually the best qualified to render

advice, if you believe the client requires it. When considering an investment of several hundred thousand dollars, the old adage, "better safe than sorry" makes good economic sense.

The accountant should be prepared to offer tax advice to the client or to seek the services of a tax advisor. Advance tax planning is extremely important to the success of a motel venture.

Bankers and realtors often can be of assistance in determining the best way to obtain the necessary financing. Normally their knowledge of motel or motor hotel operations is slight, but still they almost certainly have had considerable general experience in planning the financing of real estate transactions.

MARKET STUDY AND ANALYSIS

Whether the client plans to build, buy or lease, the CPA should stress the importance of a market study of the area. In making this study and gathering informative data the following persons or agencies have proved to be helpful: the chamber of commerce, the municipal governing body, and representative commercial and industrial leaders in the community. Generally such a study breaks down into three phases: determining the rate of economic growth of the area, determining the probable future development of the community, and determining the status of existing or contemplated transient housing and feeding accommodations.

Of these, perhaps the most important is the future development of the community. Today's good location may be tomorrow's headache if alteration of existing highways is planned. Another factor less easily determinable is the trend of the basic economy of the community. The past, present and foreseeable economic growth should be carefully analyzed in order to determine whether an area is growing or declining in importance as a travel stop. There may be changes contem-

plated in municipal laws that would impose restrictions on new or existing facilities. If the client is buying a motel currently in operation, try to determine if it is being sold because of unfavorable factors.

In studying the status of transient housing and feeding accommodations, special emphasis should be placed upon determining whether the construction of additional facilities is being contemplated in the area. Available sites should be studied and municipal officials questioned to ascertain whether construction of similar operations may follow. A list should be prepared of the available accommodations and the rates charged for them. If possible, other operators should be contacted in order to determine the occupancy of existing facilities. Of particular importance is the daily trend of occupancy. It has been found that the average small motel operator has very few statistics available; however, every attempt should be made to obtain information from other operators in the general area and from the local hotel and motel associations.

SURVEY OF EXISTING PROPERTY

If the client is contemplating the purchase of an existing property, a complete study of the physical plant should be made. Architects, consultants and possibly appraisers should be called upon for advice unless the accountant's experience qualifies him to judge the condition of the building, furniture and equipment.

Here are a few of the questions to which the client should obtain expert answers:

1. What is the physical condition of the building interior, exterior, and utilities? Is the structure sound and properly equipped in terms of heating and lighting, plumbing and weather-resistant material?

2. What exactly are the facilities (restaurant, bars, shops, group feeding accommodations and parking) and are they properly integrated for efficient operation?

3. What is the condition of the restaurant and bar equipment, laundry facilities, guest room and lobby furnishings, and are they good enough for proper service and comfort of guests?

4. Is the operating equipment (tableware, linen, utensils, cleaning equipment, grounds and other mechanical equipment) adequate for proper service?

5. If the physical plant and equipment are in poor condition due to improper maintenance, how much will it cost to restore the property?

6. Are there any feasible alterations or additions that would improve service or provide income-producing space such as stores, cocktail lounge, group-feeding facilities or additional public dining areas? What would be the cost of such changes?

CONCLUSION

In this article I have only touched upon the major points to be considered

when you get the inevitable question from a client: "Should I be in the motel business?" I would like to stress the importance of the accountant's role in handling the preliminaries, particularly the market study. Local business and municipal officials are more likely to give information to an independent accountant or consultant than to the principals in a real estate transaction. The cooperation of hotel and motel operators is more easily obtainable by the accountant, and the client can benefit from the accountant's business experience, regardless of the field in which it was gained. A word of caution—the motel and motor hotel field is complex and rapidly developing. Do not hesitate to seek professional advice because you fear losing a client. The ethics of our profession limits the work to that specifically requested, and other professional people, such as architects and consultants, are not concerned with accounting work. You can be of greatest assistance to your client if you are cautious and conservative in determining the advisability of his taking an active part in the motel or motor hotel industry.

INTERNAL AUDITING

Internal auditing is a function that is present within every business—regardless of its size. Basically, internal auditing is concerned with the examination and appraisal of controls: in seeing that the assets of a business are properly accounted for and protected, that transactions are correctly recorded, that faulty or fraudulent operations are revealed: in short, that the business is adequately protected against waste, fraud and loss.

In a small concern this work will be informally handled by the proprietor through his intimate knowledge of every facet of his business. Through keeping an eye on things generally, he is in a position to note any irregularity, wasteful operation or other deficiency. His own interest in greater profits makes him the natural guardian and constructive of critic operations. If some plan seems ineffective, he will change it.

From an editorial in
THE ACCOUNTANT [England], April 1959

Actuarial Principles and Pension Plans

By JOHN H. WILLIAMS, CPA

With the increasing importance of employee benefit plans, it is essential that the accountant have a better understanding of actuarial procedures. This article reviews the work of the consulting actuary in the field of trustee benefit plans, his funding methods, the actuarial assumptions he uses, the form in which he presents his calculations, and his professional status.

INTRODUCTION

WHAT AN ACTUARY DOES

THE writer's first acquaintance with the word "actuarial" was made in three or four chapters of an early edition of "Principles of Accounting" by H. A. Finney, dealing with a few basic elements of actuarial science. No doubt as with other embryonic accountants, the meeting was casual and, although terms such as "present value" and "annuity" were not forgotten, the word "actuarial" was not really understood. The terms "actuary" and "actuarial" are certainly much better known today than they were twenty-five years ago, but they are still far from being in common usage. Even among those familiar with the terms, there is considerable ignorance concerning the actuarial profession.

In a booklet, "Preliminary Actuarial Examinations," published by the Society of Actuaries, a general description of the work of an actuary is given.

The professional activities of actuaries include almost every important field relating to the provision of insurance or annuity benefits on either an individual life or a group basis. Actuaries traditionally have been, and still are, responsible for determining the premiums which companies charge for insurance. However, there are relatively few actuaries who work exclusively in this field. Many more actuaries are currently devoting their energies to such diverse fields as supervising the accounting procedures of insurance companies, preparing and approving the text of new policy forms, establishing appropriate rates of agency compensation, developing new methods of office administration which will successfully exploit the advantages of the newest large-scale electronic computers, providing consulting services in connection with pension plans set up by small or large corporations, and so on. The reason why the services of actuaries are needed in so many aspects of the insurance business is that in many of these areas a complete understanding and effective solution of the problems that arise requires a thorough appreciation of the mathematical structure that underlies the insurance business. Thus, although it is not unusual for many actu-

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aries to spend weeks or months without writing down an equation, proving a theorem, or engaging in other activities that may be characteristic of the professional mathematician, the unique contribution that actuaries bring to any field of the insurance business with which they are concerned is their thorough familiarity with the mathematical considerations which govern the operation of the business.

This article is limited to a consideration of the work of the consulting actuary in connection with plans providing benefits from trust funds (referred to herein as "non-insured" plans to distinguish them from plans providing benefits through an insurance carrier). It is in this field that the certified public accountant has a particular interest.

ACCOUNTING RESEARCH BULLETINS

Accountants, as much as any group, have worked with consulting actuaries over the years. The continuous increase in benefit plans as an integral part of the nation's economy has influenced this collaboration. The accounting profession has had to accustom itself to the various aspects of accounting for benefit plans, and apply traditional accounting principles to these aspects. Chapter 13, Section A, of Accounting Research Bulletin No. 43 deals with "the accounting treatment of costs arising out of past service which are incurred under pension plans involving payments to outside agencies such as insurance companies and trustees." The opinion, recommending that the allocation of costs of benefits with respect to service prior to a plan's establishment be charged to current or future periods rather than considering such costs as a charge to surplus, was originally issued in 1948.

Accounting Research Bulletin No. 47, issued in 1956, took cognizance of the variations in accounting for pension costs. The bulletin expressed

a preference for full accrual accounting of such costs, but limited its recommendation to the inclusion in accounts and financial statements of a minimum pension cost liability. This minimum amount was set forth as "the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trusted funds or annuity contracts purchased."

It is not likely that this will be the final bulletin or release to be issued concerning accounting for pension costs. In a paper presented at the 1958 annual meeting of the American Institute of Certified Public Accountants (published in the March 1959 issue of the *Journal of Accountancy*), Mr. William W. Wernitz stated: "However, the committee on accounting procedure has put paragraphs 7 and 8 of Bulletin 47 on its agenda for further consideration, and it is quite likely that some statement on the problem will be forthcoming early next year. The committee proposes also to consider the question of what is to be done when the fund exceeds the actuarially computed, necessary amounts due to unanticipated security profits, improvements in yield rates, turnover factors, and the like."

PRESENT AREAS OF MUTUAL INTEREST

In any valuation of a non-insured pension plan or welfare fund, it is imperative that the consulting actuary know the assets of the plan or fund as of the date of the study. Also, he needs to know the investment income for the year in order to compare it with the rate of interest used in the actuarial calculations. Normally, financial accountings are supplied by a trustee, although in some instances statements are prepared by certified

public accountants. In either event, the asset valuations and income as so reported are used by the actuary. The accountant, in turn, requires information from the consulting actuary for such plans. For instance, certain of the material required to be filed with the Treasury Department for approval of a pension or welfare plan (Code Regulations Section 1.404(a)-2(a)) is actuarial in nature. One of the required exhibits is a schedule which provides for the determination of the estimated future benefits payable to the twenty-five highest paid employees covered under the plan. This exhibit usually is completed by the consulting actuary. Another exhibit calls for an actuarial report certifying to the contributions payable by an employer during the taxable period and, in addition, requires a statement as to the actuarial assumptions used in the calculations.

The unfunded past service liability under a pension plan, and the prospective benefits to certain officers of a company are required for inclusion in proxy statements. Again, a certification as to the unfunded obligations under a pension plan may be desired for a balance sheet footnote. In many instances accountants request of the consulting actuary a certification of the future and past service contributions recommended for payment to a pension plan by an employer during a given year.

The pension costs and liabilities discussed in the aforementioned accounting research bulletins are normally determined by consulting actuaries for non-insured plans. It may be of interest to accountants to know that the minimum liability suggested in Bulletin No. 47 is not usually shown in an actuarial report and may require a special request from the employer or the accountant. In some instances, it may even require

a special calculation on the part of the consulting actuary.

BASIC ACTUARIAL PRINCIPLES AND TECHNIQUES

GENERAL COMMENTS

The areas of collaboration between the certified public accountant and the consulting actuary have been expanding rapidly, and the recent regulatory legislation covering benefit plans will extend these areas further. As a result of this legislation, considerable information of both a financial and actuarial nature will need to be filed with state and federal authorities. Representative groups of various accounting organizations, including the Committee on Employee Benefit Plans of The New York State Society of Certified Public Accountants, have spent much time reviewing drafts of reporting forms, statements and instructions prepared under the auspices of the agencies responsible for the administration of the legislation. Although much of the detailed information required under the legislation is financial in nature, consulting actuaries are also interested in the material to be filed. The forms provided by the U. S. Department of Labor for optional use by plan administrators in complying with the provisions of the Federal Welfare and Pension Plans Disclosure Act (effective January 1, 1959) serve as a good basis for discussing the actuarial information generally required. The reader of this article should recognize, however, that the basic principles considered herein have general applicability, and the references to the forms discussed are offered by way of illustration.

The "Description Form," Form D-1, calls for nothing that is either particularly actuarial or financial in nature. The "Annual Report," Form D-2, of course, is of considerable in-

terest to both certified public accountants and consulting actuaries. With respect to actuarial information, the Act provides that, if a plan is funded through the medium of a trust, the required Annual Report shall include the type and basis of funding, the actuarial assumptions used, the amount of current and past service liabilities, and the number of employees, both retired and non-retired, covered by a plan.

FUNDING METHODS

Part III of the Annual Report is applicable to trustee or non-insured pension plans. Item 12 A calls for a statement of the "type and basis of funding." Types of funding vary considerably. Among these types are the Unit Purchase Method (also called the Unit Credit Cost Method) and the Level Cost Method, both of which describe actuarial computations used to determine the contributions required to build up actuarial reserves prior to an employee's retirement.

UNIT PURCHASE METHOD. Under the Unit Purchase Method of funding, the present value of benefits payable for service prior to the establishment of a plan is set up as the initial past service cost. The current service cost in each year is the amount required to provide in full for the benefits which accrue during that year. The classic insured group annuity contract provides for funding on this basis. Many consulting actuaries also use this method under which experience gains or losses (later discussed) can be either applied to reduce or increase the unfunded past service cost, or applied against the present year's or the next year's current service cost. Under this method the gross premium or contribution rate applicable to an employee increases with each additional year of his age. As a very rough comparison the premiums or

contributions under this method are determined in the same way as are the gross premiums paid for term life insurance, which increase with each year of an insured's age.

LEVEL COST METHOD. Under the Level Cost Method there are various forms which the funding may take. One form of funding under this method is used in insured group permanent contracts, deposit administration contracts, and individual retirement income policies, where a level premium or contribution is established for each employee and is continued at such rate throughout his future work-life. It is also used in the type of plan where there are fixed benefits and a fixed cents-per-hour contribution. Under this method the cost for the individual at the outset is greater than under the Unit Purchase Method, but there is no increase in rate with increase in age. Again, as a very rough comparison, the premiums or contributions under this method are somewhat similar to gross premiums paid for straight life insurance which remain the same throughout the life of the insured as contrasted with increasing term premiums.

Under the non-insured plans the level contribution under Level Cost funding generally is not determined separately for each individual, but is applied to all covered employees at a rate fixed on the basis of the actuarial valuation of the liabilities of the plan as a whole. There are various methods or combinations of methods of calculation possible, including the Entry Age Normal Method, the Aggregate Cost Method and the Attained Age Normal Method.

Entry age normal method. Under the Entry Age Normal Method, the future service contribution rate is determined as that needed to fund the pension benefits of the average new entrant employee over his work-life

from the time he first entered his employer's service. When the present value of these future contributions, together with the amount of existing fund assets, is deducted from the present value of all benefit payments to be paid from the plan in the future, the balancing item is the initial past service cost. Experience gains or losses can be applied as a revision in the future service contribution rate resulting in a frozen initial past service liability; or an open-end past service liability may be used, under which actuarial gains and losses arising from past service are reflected in decreases or increases in the unfunded past service liability.

Aggregate cost method. Under the Aggregate Cost Method, the present value of all benefits expected to be payable in the future for existing employees is first determined. From this figure the amount of existing fund assets is deducted, giving the unfunded cost of all future benefits. By spreading this total unfunded cost over the future service of the existing group of employees, an over-all contribution rate is obtained. This rate is applied to the compensation of employees in a given year to determine the dollar contribution for the year.

Attained age normal method. Under the Attained Age Normal Method, the present value of benefits payable for service prior to the establishment of a plan is set up as the initial past service cost. The future service contribution rate is determined which will fund the cost of benefits on account of future service of present employees over their combined future work-life. Experience gains and losses are usually applied to decrease or increase the future service contribution rate, so that in this method a frozen initial past service liability is also used.

TERMINAL FUNDING METHOD. Fi-

nally, as compared with the Unit Purchase and Level Cost Methods, there is the Terminal Funding Method under which no contributions are made until an employee is retired. At that time, an amount equal to the full reserve on the employee's pension, i.e., the present value of prospective payments to him, is paid into a fund. In some instances, one-fifth of such full reserve is contributed in each of the five years following an employee's retirement.

Perhaps funding methods may be compared to various methods of liquidation of a debt or to various methods of depreciation used by accountants. Just as one method of depreciation acts to defer or to accelerate depreciation, so the various types of funding methods operate to defer or accelerate contributions to a pension or welfare fund. The method of funding used will not always have the identical effect upon contributions. In general, the Unit Purchase Method will produce lower contributions in the earlier years of a plan's operation, and higher contributions later on, than under a Level Cost Method. One Level Cost Method will produce higher contributions earlier than another such method, depending upon the ages and service credits of a group of employees. The Terminal Funding Method, of course, defers contributions for a considerable length of time.

A few terms may need explanation. The distinction between "prior service," "past service," "normal," "current" and "future service" as applied to pension costs is not always clear. "Prior service" may refer to service prior to the establishment of a plan, and "prior service cost" to the cost arising from such service. "Past service cost" may have a similar definition, or it may refer to cost on account of all credits accrued to the date of a given actuarial computation. "Normal cost" and "future service cost" are

generally synonymous, and pertain to the cost accruing in the future from a given valuation date. "Current cost" may mean the part of normal or future service cost applicable to a current year, or it may mean the total cost for a current year.

For the purpose of this article, the term "initial past service cost" will refer to the cost arising from pension credits earned prior to the establishment of a plan. "Past membership service cost" will refer to cost arising from pension credits earned from the date of establishment of a plan to the date of a given actuarial valuation or computation. "Past service cost" will be the total cost of pension credits accrued to a given valuation date, i.e., the sum of initial past service cost and past membership service cost. "Future service cost" will refer to pension cost on account of prospective benefit accruals subsequent to a valuation date. "Current cost" will be limited to such portion of the future service cost as pertains to a current year.

Mention has been made above of a "frozen initial past service liability" and an "open-end past service liability." The former is the unfunded past service liability which is determined at the outset of a plan's operation. Barring amendments to the plan, this liability will be increased only by the interest on the outstanding amount of the liability, and will be decreased only by employer (and in some rare cases, employee) contributions. The effect of any other experience of a plan relating to the initial participating employee group is reflected only in future service contributions. The amount of an open-end past service liability, as indicated by its terminology, will increase or decrease not only as a result of interest and contributions, but will be affected each year by the service and mortality experience of covered employees during the year preceding a

valuation date on account of service credits applicable to years before the plan started. Either type of initial past service liability determination is suitable with certain methods of funding whereas, in other instances, the method of funding used determines the past service calculation required.

Some employers have paid off their initial past service liabilities in full in a single lump sum payment. Others are funding over a ten, twenty, forty, or even as long as a fifty year period. The only limitations with respect to funding the initial past service liability would appear to be from a provision of the Internal Revenue Code of 1954 (Section 404(a)(1)(C)) stating that the income tax deductions allowable in any one year may not exceed 10 percent of the initial amount, and a ruling prescribed by the Treasury Department (Revenue Ruling 56-596) that the unfunded past service liability at any time may not exceed the initial amount of such liability.

ACTUARIAL ASSUMPTIONS

Item 12 B of Part III of the Annual Report, Form D-2, provides (1) for the attaching of a statement of actuarial assumptions used, and (2) an indication as to whether or not an actuarial report is attached. Apparently, there is nothing in Form D-2 which requires the filing of an actuarial report.

Just what are actuarial assumptions, and how are they used by consulting actuaries? Basically, the actuary applies a certain set of cost factors to a group of employee data to estimate future benefit payments and contributions. These factors, or probabilities, are based upon certain assumptions which vary with the benefit structure of a pension plan, the funding method used, the general economic cycles, or even with the methods used by the consulting actuary. Probably the two

most commonly known factors to be assumed are an interest rate and a mortality table. In making his calculations the consulting actuary assumes the investments of the fund will earn a stated yield, which is set initially by his client. From the mortality table the actuary determines the probability that employees at a certain age will survive to receive a benefit, and the expected duration of the benefit payments. Other actuarial assumptions deal with salary or wage progression, employment turnover, rates of disability, retirement ages and expense loadings. The choice of the actuarial assumptions, or the construction of new assumptions, for use with a specific group is one of the primary functions of an actuary. Over a period of years it may develop that the assumptions need revision to bring them more in line with actual experience. For instance, interest rates vary considerably over lengthy periods and, of course, the increasing longevity of the general population has required periodic revisions of mortality tables.

There is a point which accountants should keep in mind. Consulting actuaries do not consider their assumptions to be sacred. They, better than anyone else, realize that actual events can differ, even in the long run, from the best considered assumptions. The consulting actuary is interested in keeping costs as level as is consistent with good actuarial practice. He establishes his basic assumptions and reviews them each year, or at other periods, and is usually reluctant to make specific changes until a definite trend away from the original assumptions develops. He considers the effect of all the elements involved and, while one assumption may seem to be inappropriate, he will want to see the effect of all the elements. Even then, if possible, he may recommend compensating changes in more than one

assumption. Such changes may be made simultaneously with the least impact upon pension liabilities and consequently upon the employer's contributions and future pension expense.

CURRENT AND PAST SERVICE LIABILITIES

Item 12 C of Part III of the Annual Report calls for the "amount of current and past service liabilities" as of its "date of determination." The date of determination will undoubtedly be the date as of which the last actuarial valuation and report were prepared. The "amount of current and past service liabilities" will be computed by the consulting actuary on the basis of the funding methods and assumptions set forth under Items 12 A and 12 B, respectively. There may be some disagreement as to what is meant by "amount of current and past service liabilities." This might be interpreted to mean the reserve for future benefits; that is, a figure comparable to that entered on line 17 (a) of Exhibit B-1 of the Annual Report. Alternatively, Item 12 C might be interpreted to be the total actuarial liability, which might even include an actuarial liability for benefits yet to be accrued in the future by presently covered employees. A more reasonable interpretation would be the actuarial liability for benefits accrued for service to date. In most instances, this amount would be equal to the sum of the present assets of a plan plus the unfunded past service liability.

The final Item, 12 D, the number of retired and non-retired employees covered by a fund, will be available either from fund records or from an actuarial report.

AVAILABLE FUNDS VERSUS ACTUARIAL LIABILITIES

Exhibits B-1, "Summary Statement of Assets and Liabilities," and B-2,

"Summary Statement of Receipts and Disbursements," of Form D-2, must also be completed for plans providing benefits through the medium of a trust fund. In many instances these statements may be completed by the administrator directly from a trustee's accounting. In other instances, as set forth in the Act, the financial information will be "... certified to by an independent certified or licensed public accountant, based upon a comprehensive audit conducted in accordance with accepted standards of auditing. . . ." One point to be kept in mind in the completion of these statements is that a trustee's accounting usually is prepared on a cash basis with respect to contribution receipts and benefit payments, whereas the income is reported on an accrual basis.

In connection with Exhibit B-1, there is an item of particular interest to consulting actuaries which is occasionally misunderstood. This is the entry required at line 17(a), "Reserve for future benefits and expenses." This amount consists of the balance of the assets, over and above any matured payments or liabilities due, which is *available* for the payment of future benefits, and not necessarily the amount *needed* to provide the benefit payments. The amount needed at any given time to pay prospective benefits accrued for service to date is the total accrued actuarial liability for such benefits computed for entry under Item 12 C of Part III. The misunderstanding occurs because the amount available for benefits is frequently extremely large in comparison with the current benefit roll. The layman, therefore, may feel that contributions may be reduced or discontinued, or that benefits may be increased, without affecting the soundness of a fund. Lines 17(b) and 17(c) provide space for additional reserve entries. Some consulting actuaries present a detailed

segregation of reserves in their reports, but in the normal case the reserve held for future pension payments will be reported here as a single item, as will be the reserve held for welfare benefits.

THE ACTUARIAL VALUATION ACTUARIAL GAINS AND LOSSES

In addition to questions arising from federal and state legislation, there are a number of points in connection with pension and welfare funds which are creating problems for certified public accountants and consulting actuaries at the present time. Perhaps some of the problems arise from a lack of understanding of terminology.

For instance, the terms "gain" and "loss" may mean something entirely different to an accountant than they do to a consulting actuary. When used by a consulting actuary the terms refer to an "actuarial gain" or an "actuarial loss." Actuarial gains or losses result from differences in the actual experience of a fund as compared with the actuarial assumptions used by the consulting actuary. If the rate of income from investments actually earned should exceed the rate assumed in the consulting actuary's calculations, an "actuarial gain" occurs. If the assumed interest rate exceeds the actual yield, an "actuarial loss" occurs. Should pensioners die sooner than anticipated by the mortality tables used for a fund, an "actuarial gain" results. If pensioners live longer than expected by the tables, an "actuarial loss" results.

THE ACTUARIAL BALANCE SHEET

The term, "balance sheet" has acquired a common usage. The term "actuarial balance sheet," however, is not so familiar. Not all consulting actuaries prepare an actuarial balance sheet, but the statement appears in a sufficient number of actuarial reports to warrant an explanation of its structure. Also, whether the balance sheet

appears in the actuary's report or not, the same figures are presented in some manner. The actuarial balance sheet is a presentation of certain facts produced as a result of an actuarial valuation. It is used by those actuaries who believe that this form provides the clearest presentation of these basic facts. Perhaps its use is predicated on the basis that, since a client is quite familiar with an accountant's balance

sheet, he may be more likely to understand the results of the actuarial calculations as presented in this form.

Let us take the case of a pension plan which is "non-contributory," that is, one in which employees make no contributions and the cost is borne solely by the employer. An accounting balance sheet for a particular pension plan, on an accrual basis, might look something like this:

ASSETS		LIABILITIES AND RESERVES	
Cash	\$ 20,000	Benefits due and unpaid	\$ 2,000
Securities	964,000	Reserve for future benefit payments	998,000
Accrued interest receivable..	6,000		
Contributions receivable	10,000		
Total	<u>\$1,000,000</u>	Total	<u>\$1,000,000</u>

In many instances, the accounting balance sheet may be viewed as two breakdowns of assets. The "Asset" side indicates the amount of each type of asset held, and the "Liabilities and Reserves" side indicates the particular purpose for which the respective amounts of assets are held.

The actuarial balance sheet actually starts with the accountant's "Reserve For Future Benefit Payments." This reserve is compared with the actuarial present value of pension benefits payable at some future time to present active and retired employees. In some instances a portion of the "Reserve For Future Benefit Payments" is allocated for retired lives. In the above example, \$150,000 might reflect reserves held for retired employees, leaving \$848,000 as the reserves for active employees. The accounting "Reserve For Future Benefit Payments" is the amount of the "Present Assets" in the actuarial balance sheet.

The "present value" of future pension payments is a function of four factors, namely: (1) the probability of survival in the service of the employer to receive a pension benefit,

(2) the amount of the pension benefit, (3) the expected length of time that the benefit will be payable, and (4) a discount for interest from the valuation date to the various dates of expected payments of benefits. These factors are, of course, determined on the basis of actuarial assumptions such as mortality, turnover, disability and interest earnings. This present value of future benefit payments is the "actuarial liability."

The simplest method of actuarial valuation to demonstrate is the Unit Purchase Method. Here the actuary determines the pension benefits accrued for service to the valuation date, and then determines the present value of the payment of these benefits as they become due in the future. This present value is then compared with the "Reserve For Future Benefit Payments," and the resulting difference represents the surplus or deficit on the valuation date and shows whether the total actual experience under the Plan has been more favorable or less favorable than the actuarial assumptions.

An actuarial balance sheet under the Unit Purchase Method might look as follows:

ASSETS		LIABILITIES	
Present assets:		Present value of future benefit payments to present retired employees	
Retired employees' account	\$ 150,000		\$ 155,000
Active employees' account	848,000	Present value of future payments to present active employees for benefits accrued to date	
Total present assets	\$ 998,000		1,335,000
Prospective assets:		Total present value of future benefit payments	
Present value of prospective employer contributions needed to fund past service liability	500,000		\$1,490,000
Total	\$1,498,000	Actuarial surplus	8,000
		Total	\$1,498,000

As indicated above, the \$8,000 actuarial surplus represents the variation between the actual experience under the plan and the assumed experience. This surplus may then be used to reduce the employer's contributions to the plan. If the adjustment is made with respect to the year in which the experience took place, the balance sheet would be in balance and the present assets or the unfunded past service cost would be reduced by \$8,000, depending upon whether the surplus is used to reduce the year's current service cost or applied as a reduction in the unfunded past service cost. For simplicity, many plans using this type of funding would apply the surplus to the following year's current service contribution, and the balance sheet would then appear as shown above.

One more comment might be made about this particular actuarial balance sheet. The fact that the computed liability, or present value of future benefits, for employees not yet retired is \$1,335,000, whereas the funds held for such active employees are only \$848,000, is probably understandable. The difference is primarily due to the fact that the employer has not as yet liquidated the initial past service cost established at the effective date of the plan. The employer will make future contributions to close this gap. The funds held for retired employees, how-

ever, amount to \$150,000, which is \$5,000 less than the computed reserve for retired employees. This \$5,000 excess of computed liability over book reserves indicates that, to the balance sheet date, pensioners have been living longer than assumed by the actuarial tables. Due to variations in actual pensioners' mortality against the deaths assumed by the actuarial tables, it is a rare occurrence when the funds held and the computed liability for retired employees are exactly equal at any given date.

Under one form of the Level Cost Method of funding of the non-insured plan previously described, a frozen initial past service liability is established representing the present value of benefits based upon service prior to the effective date of the plan, and a percentage of payroll is computed by the actuary to cover the cost of benefits accruing after the establishment of the plan. (See previous discussion of Attained Age Normal Method.) Under this procedure, the actuary determines not only the value of the benefits accrued to the valuation date but he also determines the value of the benefits which will accrue in the future to the date the benefit payments commence. The present value of these total pension payments is then computed. Where the benefit is based upon earnings, it is necessary to include an assumption as to future salary levels.

This may be done by assuming the same salary will continue, or by assuming an increasing salary according to some scale. To offset the additional actuarial liability due to the inclusion of future benefit accruals, it is neces-

sary to determine an additional actuarial asset figure equal to the present value of future employer contributions with respect to future service.

On this basis the actuarial balance sheet might look as follows:

ASSETS		LIABILITIES	
Present assets:		Present value of future benefit payments to present retired employees	
Retired employees' account	\$ 150,000		\$ 155,000
Active employees' account	848,000		
Total present assets	<u>\$ 998,000</u>		
Prospective assets:		Present value of future payments to present active employees:	
Future service contributions	\$1,192,000	Past service benefits	\$ 900,000
Past service contributions..	<u>500,000</u>	Past membership service benefits	435,000
		Future service benefits....	<u>1,200,000</u>
Total prospective employer contributions	<u>\$1,692,000</u>		<u>\$2,535,000</u>
Total	<u><u>\$2,690,000</u></u>	Total	<u><u>\$2,690,000</u></u>

This actuarial balance sheet differs from the actuarial balance sheet under the Unit Purchase Method, because on the "Liabilities" side it shows the present value of future payments to present active employees on account of future service benefits (\$1,200,000), and on the "Assets" side it shows the prospective assets arising from future service contributions (\$1,192,000). The latter item is the balancing item. The annual future service contributions are then determined by the actuary at a rate that will provide contributions having this same value of \$1,192,000, if all the assumptions made by the actuary are exactly met. The prospective past service contribution of \$500,000 is the unfunded past service liability as of the valuation date. In plans funded by means of an open-end past service liability, the

experience gains and losses are absorbed by an adjustment in the unfunded past service liability. In such plans, the unfunded past service liability then becomes the balancing item.

The New York State Insurance Department has had under its supervision for many years a number of retirement systems which report to the Department each year on Form 11, "Annual Statement to the Superintendent of Insurance of the State of New York." Pages 4 and 5 of this Annual Statement present an excellent example of the form of a detailed actuarial balance sheet.

The explanation written here about the actuarial balance sheet has been very brief. There are variations of the methods outlined, and other methods not mentioned, which are perfectly valid from an actuarial viewpoint.

Paperwork Simplification

By HENRY GUNDERS

Six illustrative principles of good paperwork procedures are set forth as a guide to understanding the specific techniques which the certified public accountant may employ in undertaking a paperwork simplification survey for his client. Constructive service by the CPA in this area can result in increased productivity and efficiency of the client's clerical staff with a consequent reduction in costs.

ONE of the many business problems about which an accountants' advice is often sought is that of coping with rising paperwork costs. To give such advice in a competent manner or, better yet, to take the initiative by showing clients where paperwork problems exist and how they may be solved requires a knowledge of the principles that underlie good procedural practice; also, the accountant must be skilled in the analysis of existing procedural practices and must be able to develop improvements. It is the aim of this article to set forth some of these principles and to describe how a paperwork simplification study should be carried out.

DEVELOPING PRINCIPLES OF GOOD PROCEDURAL PRACTICE

Principles of good procedural practice cannot be learned by memorizing a great number of ways in which a given clerical procedure is carried out in a number of businesses. The num-

ber of conditions that cause procedures to differ, even among companies in the same line of business, is so great that almost endless variations in procedures can result. To commit them all to memory is neither possible nor necessary. Also, there is a danger that a procedure found to be suitable for one business might unwisely be assumed to be just as good for another. Instead of recognizing the real requirements that exist, the "canned" procedure might thus be installed, with unfortunate results. Instead, it is far better to become thoroughly familiar with relatively few general characteristics of good procedural practice, which should have universal application to administrative procedures in any given area of a business, be it accounting, production, inventory control, credit, purchasing and so forth.

Six illustrative principles of good paperwork procedures are set forth below in the form of questions which evaluate existing procedures in the light of these standards. They are equally applicable to small and large businesses. An example is given after each question that shows how, by testing an existing procedure in the light of the related principle, a procedural

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deficiency may be brought to light. Many of these procedural tests are closely akin to work that is usually carried out while making an audit.

SOME PERTINENT QUESTIONS FOR TESTING PROCEDURAL PRACTICES

1. *Is information recorded initially in such a way that it can later be reproduced without manual transcription?*

One of the most expensive operations in paperwork is the manual origination of data. Both this and the next question are intended to bring out the undesirability of rewriting data when it can reasonably be avoided. The preservation of such data in a form that makes later recopying unnecessary generally saves clerical costs. By its very nature, each information flow provides a temptation for the needless recopying of data when preparing the various documents involved. Whether such unnecessary work is done is easily discovered. For example, while examining transactions and the detail records of sales, accounts receivable and collections, the accountant will compare sales orders with shipping records and production orders and also with corresponding sales invoices. If the procedures call for the initial preparation of the sales order to be in such a form that the constant information (such as customer name, item description, etc.) can be mechanically reproduced while preparing all other related documents, clerical economies will generally result. The fact that these documents are not prepared or completed at the same time does not prevent the initial preparation of information in reproducible form.

2. *Is there simultaneous writing of information that must be recorded on different types of documents?*

Probably the most generally known application of this principle is found

in the methods embodied in the use of bookkeeping machines and payroll-writing boards. These "write-it-once" techniques can be used to advantage whenever a need exists for any two—or all three—of the following: (1) a unit document (e. g., the earnings stub in a payroll procedure), (2) a ledger (the employee's earnings record), and (3) a register (the payroll register).

3. *If certain information is needed again and again, can it be prepared in a permanent manner which makes it unnecessary to rewrite the information each time it is required?*

Many businesses have specifications (such as material characteristics, labor operations and the like) that do not often change. Essentially, once these specifications are written, the resulting document can be used over and over; but in many instances this efficient method is not used, and specification information is recopied each time it is needed.

For example, many companies require that all purchases be supported by properly authorized purchase requisitions. Whether this practice exists can easily be determined by an appropriate question when comparing selected vendors' invoices with corresponding purchase orders. The purpose of a purchase requisition is largely to communicate to the purchasing department what it is being asked to buy. Often this involves lengthy item descriptions. Consideration of the concept of one-time writing and repeated later use of specification data would indicate that a permanent purchase requisition — that is, prepared only once and thereafter traveling from the requisitioner to the purchasing department and back—would simplify the paperwork involved.

The same principle applies to other types of records used for internal communication of specifications, such as

production orders and preventive maintenance work orders

4. *Is the cost of doing paperwork economically justifiable in the light of benefits produced?*

In the course of evaluating the client's internal accounting control, the accountant generally finds out what calculations are checked (such as checking vendors' invoices for the accuracy of extensions and footings). Often, the cost of the checking process outweighs the amount of recoveries that result from such checking, particularly where a great many transactions of small amount are concerned. In such cases, paperwork expenses can be considerably reduced by using a suitable statistical sampling technique.

Accounting for the usage of materials is another area where a reasonable relationship of paperwork cost to benefits produced is often not found. To discover whether such a situation exists in, say, the inventory accounting procedures, the accountant may note (while checking issue requisitions to credits shown on the perpetual inventory records) that a large volume of issue requisitions accounts for a negligible portion of the total dollar amount of materials disbursed. The additional accuracy in accounting distribution that is gained is often not worth the cost of the necessary clerical work.

In most paperwork procedures the larger portion of transaction documents being processed accounts for only a small percentage of the dollars involved. Application of the test of reasonableness of paperwork cost to results may suggest that only those transactions that are significant in amount be processed in detail. The rest can often be dealt with by grouping those that are similar in nature and then making reasonable allocations.

5. *Are procedures carried out no oftener than necessary?*

As a matter of practicality, certain recurring procedures are not carried out daily but at certain intervals whose duration is often based only on tradition. To illustrate, many companies prepare payrolls weekly, or pay vendors' invoices daily. Much time can be saved by doing the job less often.

For example, the auditor may find that it would be entirely practical for his client to pay employees once a month rather than weekly, making an advance for the interim periods. Or, he may conclude that, say, four payment dates each month for vendors' invoices would permit more invoices to be grouped,—and fewer checks to be issued—without causing loss of discounts.

These same comments apply to the entire area of report preparation. While it is impossible to generalize, there are many cases where reporting periods are so short that no trend can be revealed; as a result, management may feel that no action need be taken until several later reports establish that a trend exists. If this is the situation, reports can be prepared less frequently.

6. *Are clerical peakloads avoided, without giving up the benefits of mass-production of paperwork?*

The point of time when paperwork should be done is often fairly flexible. In an effort to minimize "make-ready" and "put-away" time, documents are often allowed to accumulate for a period, and then are processed en masse. This cuts down unit processing time; on the other hand, it creates clerical peakloads. These, in turn, often cause a clerical staff to be employed that is large enough to handle peakloads, but at other times is not kept busy. It can be proved that the rate of clerical output will lessen when there is not enough work flowing in at

a rate that calls for constant reasonable effort.

In reviewing the scheduling of paperwork, the accountant should examine the high-volume paperwork areas to find out whether cycle data processing is feasible. This procedure has found wide acceptance in billing of charge accounts of customers of department stores, utility companies and the like.

TECHNIQUES FOR CONDUCTING A PAPERWORK SIMPLIFICATION SURVEY

The accountant who wishes to carry out a detailed survey in this area should follow an orderly approach in his work. In the sections that follow, specific techniques are described that have been found useful in making such a survey.

As is the case with any type of investigative work, a paperwork survey must begin with the assembling of the facts that show how procedures presently operate. It has been found that the best approach is to select a "chain" of accounting procedures, beginning where data originate, and ending with the end product, be it a ledger or a report. To illustrate, one major chain of procedures begins when a customer sends in an order; information flow then goes through the phases of order filling, shipping, billing and charging to the customer's account, ending with the collection of cash and with various sales accounting and statistical reports.

Viewing procedures as a chain of events intentionally disregards the way in which the enterprise may be organized into various departments because information flows without regard to departmental lines.

FLOW-CHARTING THE PROCEDURES

Drawing a flow chart of the procedures is a useful and rapid method for committing to working papers the different steps used in a given procedure.

This technique is the procedure analyst's way of recording facts and expressing ideas in "shorthand," much as engineers use drafting techniques. It becomes much easier to understand and visualize the interrelationships of numerous steps in a complex procedure through a study of well-drawn flow charts than through the reading of lengthy procedure descriptions. Also, the flow charting technique forces the analyst to make sure that he has not overlooked a procedure step, and that all documents are traced to their ultimate destination. Finally, flow charting helps the analyst to be certain that, in reviewing the procedure, he has not overlooked important procedural steps.

The main purpose of a flow chart is to show the interrelationship between documents in a system, and to portray the sequence and nature of the various processing activities. This means that the various documents must be graphically represented, that the flow of information must be shown (usually by a line), and that the nature of each processing step must be described by suitable symbols. A number of professional organizations have suggested standard flow-charting symbols, but as yet none have achieved universal acceptance. The symbols used are therefore largely a matter of individual preference. For purposes of illustration, however, clerical functions may be represented by the following symbols:

- —Operation
- ▽ —Transmittal
- —Checking
- △ —Filing or removing from files

The shape of each symbol tells us something about the general nature of the function being performed. If we wish to become more specific, we can use code letters in conjunction with these symbols. For example, addition could be coded as "A," posting as "P,"

transcribing as "T" and so on. At times, one or two words might be used on the flow chart to further describe the operation. We may also wish to indicate the documents being worked on by representing them by rectangles and describing their nature in a few words.

The number of copies of a document that are being prepared should be drawn. Working papers should also include a photocopy of each form—not blank but rather showing all of the entries that would have been made in a typical transaction. The facts needed to construct a flow chart should be obtained by actual interview and observation of the employee who does the work. This is necessary because experience shows that even his immediate supervisor may not know precisely what is being done, though he may know what should be done. Flow charts of existing procedures should be drawn as the interview proceeds. They can be drawn much more quickly than longhand notes of procedures could be written. Also, the technique of taking notes is much more likely to result in failing to trace each procedure flow to its conclusion than the flow-charting technique because note-taking does not force the analyst to notice and resolve the "loose ends."

The best method to be used when questioning a clerk so as to elicit complete information is difficult to describe. It depends on whether the one being interviewed is naturally articulate and communicative or merely answers specific questions put to him. At best, it is a skill learned from experience. The analyst should also go over the flow chart with the interviewee before ending the interview, to be sure that nothing has been missed.

FLOW-CHARTING TECHNIQUE ILLUSTRATED

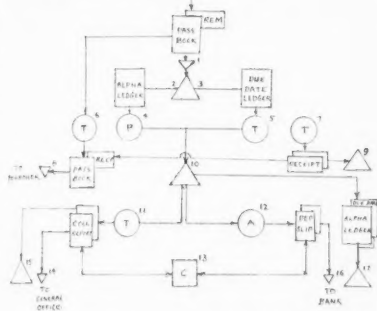
Let us now describe—first with words and then by flow charting—a sequence of clerical procedures for recording of cash receipts in the branch offices of a consumer loan company.

1. Cash or checks and a passbook are received from the borrower at the cashier's window.
2. The borrower's detail loan receivable ledger card is pulled from a file that is arranged in alphabetic sequence.
3. The borrower's detail loan receivable "due-date" ledger card is pulled from another file that is arranged according to date on which payment is due.
4. The "alphabetic" ledger card is posted.
5. The posting in step 4 above is transcribed to the "due-date" ledger card.
6. The borrower's pass book is posted.
7. A receipt—in duplicate—is written.
8. The passbook and, on request, the original of the receipt are returned to the borrower.
9. The duplicate receipt is retained in bound-book form.
10. Both detail ledger cards are placed in the cash drawer, together with cash remittances, to remain there until the close of the day's business.
11. After the close of the day's business, a report of the day's collections is prepared in duplicate.
12. Cash receipts are listed on a duplicate deposit slip.
13. Totals shown on the deposit slip and the collection report are compared.
14. The collection report original is mailed to the General Office.

15. The collection report duplicate is filed at the Branch Office.

16. The deposit slips and the remittances are sent to the bank.

A flow chart of this procedure is shown below; the number shown next to each step relates to the procedure description above.



The symbols used in the flow chart help the analyst spot functions that are basically unproductive, such as transcribing, filing and refiling, and so forth.

MAKING A CLERICAL TIME AND TRANSACTION VOLUME STUDY

To complete the fact-finding needed for the paper work simplification study, the analyst should obtain information about the volume of paperwork transactions and the time required to perform each processing step. Such data help the analyst decide whether volume and time factors are sufficient to justify machine-accounting procedures. They provide a basis for calculating the savings in clerical time that are expected to result from procedural changes. They allow him to form an opinion concerning the general productivity of the client's office personnel. Finally, these data are needed to estimate the costs of clerical effort that is needed for each of the several alternative improvements of present methods that usually exist. With these data, the

analyst will be less likely to make the mistake of comparing theoretical productivity under an ideal system with actual present productivity, with all its inefficiencies.

In view of these benefits of clerical time and volume statistics—and those listed are by no means exhaustive—it is surprising that most companies have little idea of their clerical costs expressed in terms of accounting functions (i.e., how much does it cost to complete a payment transaction?). This lack of what, essentially, is a type of distribution cost accounting is encountered in many other areas of distribution activities. Costs of production activities, on the other hand, have been known by most companies for many years.

Numerous methods of making clerical work measurement studies exist. To list but a few, there are ratio-delay studies (a type of sampling), stopwatch studies, studies using predetermined times arrived at by micro-motion film, and so forth. However, the unit time standard technique is the most practical method for the practitioner working with a client of medium or small size; it is the only one that will be described here in detail.

UNIT TIME TECHNIQUE

Unit time standards may be defined as statements of the time needed to do a given unit of work, as reported by the employee who does it. The flow chart of the existing procedure should form the starting point for the clerical time and volume study. The steps in the procedures, arranged in reasonably large groups of operations, should be listed on a columnar work sheet, allowing for three blank columns that will ultimately be used to record the number of documents handled, the elapsed time, and the time per unit of work.

The unit of work should be de-

scribed in sufficient detail to permit comparison of unit times. To illustrate, it is not sufficient merely to refer to "an invoice" or "a purchase order." In both cases, the number of line items have an important bearing on the unit time that will be reported; therefore, both the number of documents and the number of line items should be reported on, particularly if averages are not available when beginning the study.

The columnar work description sheets should be prepared on some type of duplicating master, so that a sufficient supply of forms can be reproduced to permit daily reporting of each clerk's time on one sheet. The reporting period should be long enough to be representative of any short-range fluctuations that may result, say, from a monthend period.

Employees should do their own counting of documents handled. Often, measurement of a stack of documents or establishing counts by noting the number of the first and last document of a prenumbered series to be processed that day will give adequate results. Employees should also record their own time. The analyst knows, at the outset, that a certain amount of non-productive time exists which the employee will spread over the day's tasks. The extent of this can be determined later by measuring the time actually taken by the employee to accomplish what he previously reported to be an hour's work. This will usually take considerably less than one hour. Some portion of this unproductive time should be considered to cover a 10-15 percent allowance for personal time, fatigue, or unavoidable delay.

Each day's work sheets should be checked by the supervisor of each clerical unit, and any questions should be resolved while the clerks can still recall the day's activities. At the end

of the reporting period the daily sheets should be summarized so that a composite clerical time and volume picture will be available.

ANALYZING FLOWCHARTS AND DEVELOPING BETTER METHODS

The purpose intended to be served by each step shown on procedural flowcharts should be questioned during the analysis of existing procedures. This questioning should serve to reveal any principles of good procedural practice to which existing procedures do not adhere.

When this questioning process is applied to the brief case study set forth earlier, the analyst will find the symbol T on several occasions, indicating that the same data are rewritten several times. In ascertaining whether this is necessary, he would form the opinion that posting of the two ledger cards could be combined, and that the collection report could be prepared simultaneously at the time of ledger card posting. He would ask himself whether, in place of the pass book, a prescheduled list of the diminishing loan balances and a coupon book would make it unnecessary to use a pass book, and would also save the cost of returning the pass book to the borrower. He would question the need for maintaining two detail loan ledger cards for each borrower. He would wonder why the ledger cards cannot be replaced in their proper place in the files immediately after posting, so that it would be unnecessary to refile them later. The need for a receipt and its duplicate in book form would be challenged in favor of stamping a coupon stub "paid," or having the borrower's cancelled check be considered as a receipt.

The accountant would then attempt to translate the answers to each of these queries into an approach for simplifying the procedure. Here is

such a revised cash receipts procedure, in its simplified form.

1. Cash or check and the payment coupon are received from the borrower at the cashier's window.

2. The borrower's detail loan receivable ledger card is pulled from a file that is arranged in alphabetic sequence. (Due date is notched in the margin of each ledger card, for rapid determination of delinquent loans.)

3. Postings are made simultaneously to the borrower's detail ledger card, the collection report, and the receipt (in the event the borrower has failed to bring his payment coupon, and pays in cash). A multi-copy board is used for this purpose. The ledger card is refiled immediately after posting.

4. The receipt is given to the borrower, or the payment coupon stub is stamped "paid," and returned.

5. Cash receipts are listed on a duplicate deposit slip.

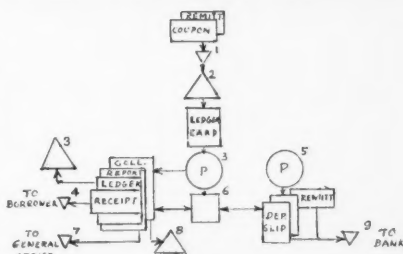
6. Totals shown on the deposit slip and on the collection report are compared.

7. The collection report original is mailed to the General Office.

8. The collection report duplicate is filed at the Branch Office.

9. The deposits slips and the remittances are sent to the bank.

The flowchart of the simplified procedure would look like this.



The revision of this procedure sequence has accomplished (1) reduction of clerical work from seventeen steps to nine, (2) consolidation of five postings into one, (3) lessening of the likelihood of making posting transcription errors through posting all documents simultaneously, and (4) faster release of receipts to bank.

The technique of paperwork simplification is another one of the tools available to the professional accountant. By using paperwork simplification principles and procedures, he can render constructive services that will aid his client's clerical staffs to increase their productivity and efficiency.

THE CPA AND POLITICS

The CPA's training and experience are more closely related to every aspect of business than any other single profession or occupation. Therefore I feel safe in saying that the CPA degree is the highest academic measure of proficiency in the "Science of Business." Government today, local, state or national, is one of the biggest and most complex of all businesses. . . .

A very good argument that CPAs should get in politics is that from some profession must come the leadership to halt this cancer of economics called "Inflation." I believe CPAs best understand the problem and can furnish the needed leadership.

JOHN K. DAVIS, JR., "The Certified Public Accountant in Politics," CPA NEWS BULLETIN (Maryland), May 1959

New York State Tax Forum

Guest Editor—MORTON GELLER, CPA

FRANCHISE TAX—FOREIGN REAL ESTATE CORPORATIONS

Section 182 of Article 9 of the New York State Tax Law imposes a franchise tax on real estate corporations. These types of corporations pay an annual tax based upon the value of their assets and an additional tax based upon dividends actually paid to stockholders. Corporation earnings which are not distributed escape annual taxation. At the time of corporate liquidation, these "undistributed earnings" are subject to tax.

Under the law as it existed previously, annual taxes and taxes at the time of liquidation were imposed on both domestic and foreign real estate corporations. However, a foreign real estate corporation was able to avoid the liquidation tax by liquidating its assets in this state and continuing to do business in another state. This type of partial liquidation of a foreign corporation relieved it from all further New York tax liability with respect to any subsequent distribution of earnings, even though realized while the corporation was doing business in the State of New York.

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This discrimination between foreign and domestic corporations is eliminated by an amendment to this section which is contained in Chapter 290 of the Laws of 1959. Effective April 8, 1959, the date the law was enacted, a tax is now imposed on the undistributed earnings of foreign corporations at the time they completely liquidate their assets in New York State, exactly in the same manner as the tax is imposed on both domestic or foreign corporations at the time of complete liquidation. In order to avoid double taxation of such a foreign corporation if it should resume doing business in New York State, Section 182 was further amended to provide that in such case no tax shall be imposed on any amounts previously taxed. Further, Section 192 of Article 9 of the tax law now requires the filing of a franchise tax report by a foreign real estate corporation which ceases to do business in New York.

FRANCHISE TAX AND SUBCHAPTER S

Another measure conforming the state tax laws with the federal income tax rules is to be found in Chapter 289 of the Laws of 1959.

Under the prior provisions of the New York State Tax Law under Subdivision 9 of Section 208 and under Subdivision 3 of Section 211, the definition of "entire net income" for the

ED. NOTE: For an interim period, until a permanent departmental editor has been selected, this department will be conducted by guest contributors.

purposes of taxation under Article 9-A is presumably the same as "net income" for federal income tax purposes. However, the Internal Revenue Code of 1954 eliminated "net income" as the tax base and based the tax on corporations on "taxable income." This change in 1959 amends the definition of "entire net income" where it refers to "net income" and now calls it "taxable income," as noted in the Internal Revenue Code. This change illustrates the difficulty of piecemeal conformity.

The Technical Amendments Act of 1958 added Subchapter S to the Internal Revenue Code of 1954 permitting small corporations under certain circumstances to elect not to be subject to federal income taxes. Under such circumstances, the corporation's income is taxed pro rata to each shareholder. Therefore, Subdivision 9, paragraph (g) of Section 208 is amended to provide that the entire net income of such corporation for franchise tax purposes is the federal taxable income which it would have been required to report if it had not made the election.

Chapter 289 also amends Subdivision 3 of Section 211 which requires corporations subject to franchise tax to file notices of federal changes and the State Tax Commission is then authorized to issue assessments on the basis thereof. Since the income of corporations electing under Subchapter S is taxable to the shareholders, any change in the taxation thereof would be reflected in the changing of the stockholder's income. Therefore, the new law requires the shareholders of such corporations to report federal changes in their income.

The amendments contained in Chapter 289 apply to reports for any year or any period commencing on or after January 1, 1954.

It should be noted that on approv-

ing the bill making the changes in the Business Franchise Tax Law, that is, Chapter 289 of the 1959 Laws, the Governor stated that while this bill does not adopt the substantive changes made in 1958 with respect to the federal taxation of "small business corporations," he is asking the Commissioner of Taxation and Finance to study the federal experience for possible recommendation to the next session of the Legislature.

TREASURY STOCK

Another piecemeal attempt at conformity with the Internal Revenue Code is to be found in Chapter 86 of the 1959 Laws. The new law amends Subdivisions 5 and 7 of Section 208 of Article 9-A of the Tax Law, eliminating treasury stock from the term "investment capital" and from the term "business capital" for the purpose of computing the franchise tax on corporations.

Under the prior law, treasury stock was considered as "investment capital," and therefore it was included in computing the alternative tax on gross assets and the investment allocation percentage of a corporation. Section 1032 of the Internal Revenue Code of 1954 provides that no gain or loss on sale of treasury stock is considered in computing net income. Such treatment is also in accord with accounting theory, which considers treasury stock as an offset against capital stock or surplus rather than as an asset. Since no gain is recognized to a corporation on the receipt of money or other property in exchange for treasury stock for federal income tax purposes, it should not be considered in computing income allocable to New York, and by excluding treasury stock from among the assets this conforms in principle with the provisions of Section 1032 of the Internal Revenue Code.

ESTATE TAX ON EMPLOYEES OF TAX-EXEMPT ORGANIZATIONS

Accompanying the bill which was later enacted as Chapter 126 of the Laws of 1959 is the following statement by the Department of Taxation and Finance: "It has been the consistent policy of this State to conform Article 10-C of the Tax Law to the federal statute with reference to items included in the gross estate and deductions allowed for estate tax purposes." The area of conformity here relates to a recognition that pension payments receivable by a decedent's beneficiary under a pension plan or similar contract is subject to estate tax only in proportion to the decedent's contributions. If the pension plan is a so-called "qualified" plan for federal income tax purposes, the employer's contributions are not attributed to the decedent, and the payment to his beneficiary is exempt from estate tax to the extent that it was provided by his employer. The amended law recognizes that employees of religious or charitable organizations may have similar benefits but the plan of its employer may not be qualified for federal tax exemption since the religious or charitable organization may be tax-exempt and therefore is not required to adopt pension plans or retirement plans which qualify for income tax exemption or deduction. The amended statute gives employees of tax-exempt organizations estate tax benefits corresponding to those available to the employees of business concerns.

INSTALMENT PAYMENTS OF CAPITAL GAINS AND NON-RESIDENTS

The New York State Tax Law at Section 358(a) permits an individual taxpayer to use the instalment basis for reporting his gains where the taxpayer makes a casual sale of personal

property for a price exceeding \$1,000 or a sale of real estate where the initial payments do not exceed 30 percent of the selling price.

The Legislature enacted an amendment to this section of the law which requires non-residents to file a bond as a condition to elect the instalment basis of reporting gain and requires the reporting of instalment payments on which tax was deferred in the case of a change of residence.

The purpose of this amendment was to avoid the evasion of tax. Where a non-resident elected to defer, the Tax Department found considerable difficulty in collecting the tax on subsequent instalments. The same problem arose in the case of a taxpayer who subsequently changes his residence. There was also a question as to the taxability of subsequent instalments after a change of residence. In this connection, Section 367-a of the Tax Law now requires the payment of tax at the time of change of residence on any instalment payments on which the tax was previously deferred. However, in order to prevent an undue burden of tax on the person changing his residence, the amendment permits a continued deferment of tax if a bond securing payment thereof is filed. The amendment applies to returns for any taxable year or period commencing on or after January 1, 1959, except that the amendment applies to all sales or other disposition of property occurring on or after January 1, 1958.

UNIFORM GIFTS TO MINORS ACT

A new "Uniform Gifts to Minors Act," effective July 1, 1959, was passed as Chapter 233 of the 1959 Laws. In approving this legislation, the Governor stated that this Act had already been adopted in substantially the same form in more than 30 states. He added that this Act is a definite im-

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provement over the 1956 law, which while helpful in facilitating gifts of securities to minors did not permit gifts of money, nor were trust companies permitted to act as custodians.

This is now changed by the adoption of the new "Uniform Gifts to Minors Act." The gift is made by paying it to a bank or a broker for credit to an account in the name of the donor, or of an adult member of the minor's family, or of a guardian of the minor, or a trust company followed in substance by the words "As custodian for ———, a minor, under the New York Uniform Gifts to Minors Act."

A gift of money, just as a gift of securities, would be irrevocable and would convey to the minor complete ownership to the money delivered to the custodian, although the custodian would maintain control over the subject matter of the gift or over income from the subject matter of the gift which is in his custody. The custodian would apply so much, or the whole thereof, as he might deem advisable, for the support, maintenance, education and benefit of the minor. Such action could be taken with or without court order or without regard to the duty of the custodian or any other person to support the minor or his ability to do so, and without regard to any other income or property of the minor which may be applicable or available for the purpose.

Many savings bank accounts are now held by parents or others in their own name but in trust for minors. For income tax purposes, the grantors of these "Totten Trusts" must include the interest earned from these accounts in their own income tax returns, although

it is intended that these accounts be held exclusively for the minors. The title of these accounts may now be transferred to "custodian" type ownership. The bank account may now also serve as a depository for dividends collected on securities held in the name of custodians. Furthermore, it is possible to avoid the estate tax question which arose when a parent-custodian died before his child reached the age of twenty-one, by use of a bank or trust company as the custodian. Thus, the inclusion of the custodian account in the estate of the parent will be avoided.

TRUSTS—ACCUMULATION OF INCOME

In New York, income of trusts could not be accumulated except for the benefit of identified minors. This provision was modified for new trusts of both personal and real property commencing on or after September 1, 1959. Income may be accumulated for the period during which property may be held in trust under the present New York State rules. These amendments are contained in the 1959 Laws in Chapters 453 for personal property and 454 for real property.

Instead of annual distributions of income to beneficiaries who are in high income tax brackets, the income may be accumulated with little or no income tax payable by the trust.

Flexibility in distribution of income is also afforded in other ways under this new legislation. It is strongly recommended that, where appropriate, taxpayers be urged to consult counsel to determine the advisability of creating accumulation trusts.

Accounting at the SEC

Conducted by LOUIS H. RAPPAPORT, CPA

COMBINATION OF PURCHASE AND POOLING

Sometimes a business combination may be effected under circumstances in which it appears that the combination results, in part, from a purchase and, in part, from a pooling. Assume, for example, that Corporation A acquires for cash a majority of the stock of Company S, which thereupon becomes a subsidiary of A and is included in the consolidated financial statements of A and its subsidiaries. Thereafter it is decided to merge S into A by having the shares of S held by the minority interest convert into shares of A. If all the other attributes of a pooling are present, it would seem that the combination could be treated for accounting purposes as part-purchase and part-pooling.

This form of combination has probably occurred several times. The writer recalls one such case which came under SEC review. U Corporation had acquired for cash about 55 percent of S Corporation. S made a product that was used by U in its manufacturing processes. The acquisition of the S stock was made by U to assure the latter of a dependable source of raw material, and there was a large volume of sales between the companies on the same terms as ap-

plied to other customers. Both companies had securities listed for trading on a national securities exchange.

Upon the acquisition of control of S by U, some of the directors of the subsidiary became directors of the parent, and some of the directors of the parent became directors of the subsidiary.

Several years later the directors of both companies considered that it would be advantageous to merge S into U. An agreement of merger was drawn up providing for the merger and submitted to stockholders of both companies for approval or rejection. Inasmuch as it was intended that proxies would be solicited to approve the merger, proxy statements were prepared by both companies and filed with the SEC under the provisions of its proxy regulation.

The merger agreement provided that the shares of S (except those held by U) would convert into shares of U. This meant that, upon the merger becoming effective, the minority shareholders of S would become shareholders of U, the surviving company. The merger agreement also provided that the directors of the surviving company would be those of the parent and that the principal officers would be drawn from both companies.

The financial statements in both proxy statements were identical. Both proxy statements contained financial statements of U and subsidiaries (in-

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cluding S) as of a recent date and for the three years then ended and financial statements of S as of a recent date and for the three years then ended. In addition to the consolidated statements of U, there were submitted unconsolidated statements of U in view of the materiality of S and the minority interest in that company.

Pro forma statements giving effect to the merger were not submitted, although a pro forma condensed summary of earnings was furnished which combined the earnings of U and S. The summary was not certified by independent public accountants. The summary (with dollar amounts omitted) was as follows:

PRO FORMA SUMMARY

There follows a pro forma summary of the combined earnings of U and S wherein elimination has been made of intercompany sales, dividends, and profits in inventory, and of related federal taxes on income.

Net sales and revenues.....
Income before income and excess profits taxes
Net income
Earnings per share on basis of shares of the Surviving Company to be outstanding upon the merger becoming effective

The effect of the merger on the capital and surplus of the surviving company was stated in a separate paragraph in the narrative section of the proxy statement as follows:

If the proposed merger had been effected as of (date), then, on such date, the outstanding capital stock of U as the Surviving Company would consist of.....shares of Common Stock having an aggregate par value of \$..... and the earned surplus would amount to \$....., arrived at as shown below, the latter being the sum of the earned surplus of U and S consolidated and the equity of the minority interests in the earned surplus of S. There would be no capital surplus created as a result of the merger.

Earned surplus of U, separately as shown in Exhibit —
Earned surplus of S, as shown in Exhibit —

Less:

Portion applicable to present holdings of U, at date of acquisition, applied as a reduction of the fixed asset amounts, including intangibles, of U and its subsidiaries consolidated

Portion applicable to present holdings of minority interests, as shown in Exhibit —

Portion representing intercompany profit in inventory, eliminated in consolidation

Remainder applicable to present holdings of U, arising since acquisition

Earned surplus of U and S consolidated

Minority interest in earned surplus of S, as above....

A slightly different result was obtained in another case in which there was first an acquisition of a minority interest, then a pooling.

G Corporation acquired for cash 17 percent of the common stock of C Corporation in 1953. Both G and C were listed companies. G later represented that this initial acquisition was made with a view to merging the operations of the two companies provided this action proved beneficial to both companies and their share owners.

About a year later it was proposed to merge the companies, with G to be the surviving company. Proxy statements were prepared and filed with the SEC. Stockholders of both companies were requested to approve the merger, and proxies were solicited to that end.

The proxy statements contained financial statements and earnings summaries of both G and C. The only pro forma statement was a balance sheet in columnar form giving effect to the merger. The merger was accounted for on the basis of a pooling of interests. The pro forma balance sheet was merely a combination of the balance sheets of G and C (including the earned surplus accounts) and the elimination of inter-company holdings.

Administration of A CPA Practice

Conducted by MAX BLOCK, CPA

UTILIZATION OF JUNIORS

Many practitioners are experiencing, in varying degrees, an evolution in the utilization of juniors. This development has come about for several reasons, especially these: present advanced salary scales, increase in mechanical and electronic bookkeeping methods, and the inadequacy of the supply of manpower quantitatively and qualitatively.

Smaller practitioners find that they cannot use junior help as freely as they did years ago because clients' fees have not all increased enough to cover the higher costs. The very simple checking functions, especially those that are carried out virtually on a detailed audit basis, now require fees that are just uneconomical for many small businesses. Practitioners so affected have dealt with this problem in several ways, of which the following are representative.

Testing is being adopted more widely where not previously employed, and the extent of tests, where in effect, is being reduced, without losing sight of auditing standards. A change of

policy in this respect can create client-relation problems unless dealt with courageously and straightforwardly by the practitioner. He must inform the client of the change at the outset. In this connection he should point out the possibility that some errors and even embezzlements may not be detected by the accountants. Nevertheless, this hazard must be weighed against the higher cost that would otherwise be involved and the fact that there are pitfalls even in the case of more detailed audits. The increased importance of internal control and of the owner's vigilance must be discussed, all justified by the saving thereby effected.

Another approach is the pruning of audit programs to weed out useless and unimportant operations, and to improve the efficiency of the others. Better and quicker staff development is an important factor in developing profitable production by staff. The reduction of the breaking-in period of neophytes is most important. In the early stages, beginners are an economic burden which must be eliminated as quickly as possible. Good staff training can be effective in this respect.

Some procedures formerly performed by the accountants are being transferred in part, sometimes even in full, to the client's organization, also without violation of prevailing audit standards. In this instance, too, the citing of the potential savings will in-

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fluence many businessmen to agree to the transfer.

Efficient staff utilization becomes increasingly important as the dollar cost of idle time increases with the rising salary scales. There is considerable literature available on the practical spreading of work and other efficiencies that serve to minimize idle time. Conditions that are responsible for idle time must be vigilantly analyzed to benefit from the experience. Efficient programming, and client cooperation by being really ready for audit, can save junior as well as other staff time.

There are some hardy practitioners who shun junior help, using men of semi-senior rank instead. They feel that the variation in salary scales is not so large as to be uneconomical. Thereby, they claim, they avoid the problems and heartbreaks of breaking in and dealing with beginners. Their policy is supported by the fact that the junior cycle has been considerably reduced by better schooling, improved staff training, better audit techniques, and by the greater pressures for advancement. Men don't remain juniors as long as they used to.

The subject of the evolution of the junior accountant, and its impact, is deserving of attention.

SURVIVAL OF ACCOUNTING FIRMS

Accounting firms can suffer from the infirmities of old age, as man does. Some fade away over a period of years while others disappear dramatically by dissolution or by disintegration. Some of these terminations might have been avoided by sound, long-range planning and by timely, effective execution of the plans.

The old age infirmities are conditions such as loss of dynamism, complacency, carelessness, inattention to personnel and client relations, slackening in self-education and staff train-

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ing, in brief, a state of "coasting" or "living on past laurels." These conditions arise where new and younger partners are not admitted into a firm, where private business interests of the partners compete for time and attention needed for the accounting practice and where, strangely, there exists the desire to just fade away, no plan for perpetuation having been made and no logical heirs exist. The same debilities can affect individual practitioners to an even greater extent than firms.

When a firm appears to its staff to be on the downgrade, a loss of morale naturally develops. Men see their jobs jeopardized, causing them to cast about for new positions or to set up competitive accounting offices. Such repercussions may bring about a more speedy demise of the firm than would otherwise come about.

Local firms are affected by two

other conditions of increasing magnitude. The first is that many small independent manufacturers and distributors are disappearing annually because of inability to compete with larger and national companies, with a resultant loss of clientele to accounting firms. New entries into the field of business are not as numerous, except in new fields such as electronics. For the new businesses there are more accountants than ever to vie for their selection as auditors. Accountants who serve very small businesses mainly, particularly retail and service trades, do not have a similar problem because the number of such businesses in existence is as large as ever, though revolving.

Another serious problem for some accounting firms is their inadequacy to meet the increasing and more complex demands of clients for services. In this age of management services, involved tax laws, and electronic installations, accountants who are not equipped to meet the new needs will increasingly lose clients to the alert, progressive firms. Such losses are avoidable if the problem is recognized at an early stage and effective action is timely taken. In some instances the most practical solution may be a merger of accounting firms, or the addition of specialist partners.

The last major problem to be considered is that of partners' disagreements and the resultant dissolutions of firms. Personality differences are the cause of many dissolutions, some of which might have been avoided if advice and counsel had been sought. Other disagreements stem from disparities in economic contributions that show up years later. Even in such cases, excluding extreme situations, dissolution can be avoided by straightforward discussion of the problems, and by such adjustments of profit shares and salaries as are wanted.

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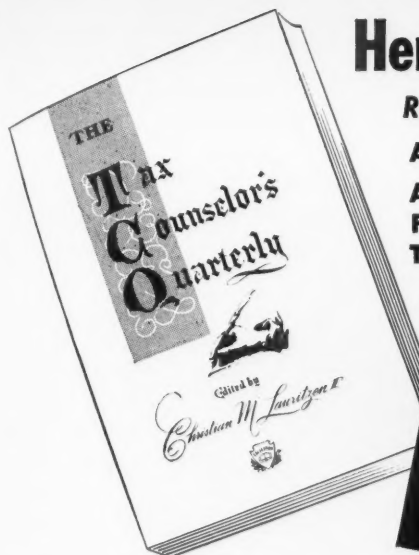
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Payroll Tax Notes

Conducted by SAMUEL S. RESS

COVERAGE EXTENDED UNDER WORKMEN'S COMPENSATION AND DISABILITY BENEFITS LAWS

The Workmen's Compensation and Disability Benefits Laws were amended at the last session of the State Legislature so as to provide for compulsory coverage under both of these laws of employers of three or more employees. Both measures become effective January 1, 1960. Those employers who are already required to provide workmen's compensation coverage under existing law, even though they have fewer than three employees, such as employers of employees in hazardous occupations or those specifically set forth in the law, will not be relieved of their obligation by reason of the enactment of this bill.

Small accounting firms, with three or more employees, not presently carrying workmen's compensation or disability benefits insurance coverage for their employees, are also affected by the above enactments.

SAMUEL S. RESS, an associate member of our Society since 1936, is a member of the New York and Massachusetts Bar. He is engaged in public practice in his own office in New York City specializing in payroll taxation and labor-management matters. Dr. Ress is a member of the Society's Committee on New York State Taxation and chairman of its Subcommittee on Unemployment Insurance.

UNEMPLOYMENT INSURANCE EXPERIENCE RATING TRANSFER

If an employer transfers his entire organization, trade or business, the transferee takes over the transferred employer's unemployment insurance account, including its balance and all other aspects of its experience rating. The account taken over remains chargeable with respect to benefits paid after the transfer, based on employment in the business prior as well as after the transfer.

In a recent decision handed down by the Unemployment Insurance Appeal Board (Case No. 65,558-58), the Appeal Board sustained the employer and overruled the Industrial Commissioner's contention that, under Section 581.4 (a) of the Unemployment Insurance Law relating to transfers of accounts, the employer should be deemed to have taken over the account and experience of the other employer in proportion to the payroll or employees assignable to the transferred portion of the latter's organization, trade or business. The facts in the present instance which enabled the employer herein to avoid being saddled with the unfavorable experience of the other employer, was the lapse of time during which there had been a complete cessation of activity on the part of the predecessor employer. Since the continuity of operations had been broken, the transfer of experience was ineffective.



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Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary

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DECISIONS AND RULINGS

"SUBSTANTIAL PART OF NET INCOME" IN COLLAPSIBLE CORPORATION CASES

The following case dealing with an allegedly collapsible corporation arose under the 1939 Code, but the sections pertinent to the decision are substantially the same as those under the 1954 Code. Accordingly, the holding in this case may have great significance.

The taxpayers involved were stockholders of a corporation which was organized to acquire a tract of land in Florida. It was intended to subdivide the land, a great portion of which was to be improved and sold, and one section of which was to be used for the erection of a hotel or motel to be operated by the corporation. The corporation was unable to comply with requirements necessary to finance the hotel. During a period of about a year, it sold some of the lots, realizing approximately one-third of the total income which could be reasonably expected to be realized from the sale of all of the property. Because sales were falling off, because the financial situation became precari-

ous, and because it was necessary for one of the stockholders who was principally active in the sale of the lots to take his wife away because of her health, the two remaining stockholders sold their shares in the corporation to a syndicate at a profit. The syndicate dissolved the corporation and sold the remaining lots over the next three years.

The Commissioner asserted that this was a collapsible corporation and that the gain on the sale of stock was taxable as ordinary income under Section 117(m), IRC 1939. The taxpayers asserted that the corporation was not collapsible because: (1) there was no intent for the corporation to be formed or availed of with the view to the sale of the stock prior to the realization by the corporation of a substantial portion of the net income to be derived from the sale of the property; (2) the sale of the stock was caused by circumstances arising *after* the purchase and development of the property; and (3) the sale of the corporation stock occurred not prior to but after "the realization by the corporation . . . of a substantial part of the net income to be derived from such property."

The Court, holding for the taxpayers on point number (3), stated that it was not necessary to make a decision on points (1) and (2). This is unfortunate since it might have supplied some much-needed clarification on the question of "circumstances arising after the purchase . . . of the property." However, the Court did rule that 30 percent constitutes a "substantial part" of the net income to be realized.

Dismissing the Commissioner's argument that a "substantial part" was equivalent to the words "substantially all," the Court stated that the question to be decided "is whether the realized income is a substantial part . . . and not whether the unrealized income is a substantial part." The Court pointed out that there could be two or more "substantial parts" of a whole and that "therefore a finding that the unrealized part . . . is substantial does not preclude a finding that the realized part . . . is substantial." It further held that in determining whether the part realized prior to the sale was a substantial part, the total net income to be realized "must be approximated as of the date of the sale . . . on the assumption that the cost basis and accounting methods used by the corporation in measuring its net income from the property at that time will remain static." This must be so because the acquiring syndicate would have a higher basis and therefore the gain would be less than it would have been to the original corporation.

In determining that 30 percent of

the income was a substantial portion, the Court resorted to the ordinary "dictionary meaning," and thus decided in favor of the taxpayer.

It should be noted that there were five dissents to this decision. Thus, there is a good probability that the Commissioner will appeal the case and certainly the probability that he will not acquiesce. (*James B. Kelley, et al.*, 32 TC No. 11.)

TERMINATION OF SHAREHOLDER'S INTEREST

Section 302, IRC 1954, delineates situations wherein distributions by a corporation in redemption of its stock are to be treated as payment in exchange for the stock rather than a dividend in respect of the stock. Among the transactions qualifying under this section as an exchange is the complete redemption of all of the stock of the corporation, owned directly or indirectly by a shareholder. However, to come within this provision it is necessary that there be a "termination of interest" of the shareholder. Such "termination of interest" is defined in Section 302(c)(2)(A)(i) as occurring when "immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director or employee), other than an interest as a creditor."

The Commissioner's interpretation of this section would deny its shelter to a taxpayer who would surrender all of his stock in a corporation in exchange for cash and notes representing a substantial sum of money, and who wished to safeguard his receivable by having his attorney become a member of the board of directors. Since the retiring shareholder planned to move away, he wished protection by having his attorney determine that the conditions of the stock redemption agreement were observed.

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The Commissioner holds that the attorney would be an agent of the taxpayer, and that no matter how limited his powers might be (they were to be limited to observer in order to see that the provisions of the redemption agreement were observed), the provisions of Section 302(c)(2)(A)(i), quoted above, would be violated, and the distribution would be a dividend. The Commissioner observes, however, that should the attorney attend the board of directors meetings as an observer with no official capacity, the requirements will have been observed and the situation saved. (Rev. Rul. 59-119, IRB 1959-15, 10.)

TREATMENT OF A CASH BASIS CORPORATION UNDER SECTION 337

Section 337, IRC 1954, provides that if a corporation distributes all of its assets (except those retained to meet claims) within twelve months of the adoption of a plan of liquidation, no gain or loss shall be recognized to it from the sale of *property* during the twelve-month period. "Property" does not include inventory or property held primarily for sale to customers in the ordinary course of its trade or business, and certain instalment obligations except in the case of a bulk sale to one person in one transaction.

What then are the consequences to a cash basis corporation which holds notes evidencing loans made in amounts of less than the face value, when it sells its assets in bulk during a twelve-month period following adoption of a plan of liquidation? Being on a cash basis, it will have picked up no income on the notes prior to the date of sale. The purchaser will report income dating only from the date of sale. This is obviously contrary to the intent of Section 337 which is directed to excluding gain resulting from the unrealized appreciation of business property.

Explaining that the increase is not due to appreciation in value of the notes, but to the accumulation of interest which would have been reportable by an accrual basis taxpayer, the Commissioner rules that the selling corporation is taxable upon the interest earned to the date of sale under Section 61. (Rev. Rul. 59-120, IRB 59-15, 13.)

Although the ruling covers only the unreported income on the notes, it is probable that it would also apply to accounts receivable and any other assets (except inventory which is specifically excluded by Section 337(b)(2)) which include unreported income. Based on the reasoning that income per se is not property (until it has been reported?), it would seem that any items which, under a change in accounting method from cash to accrual basis, would produce income in the year of the change, would likewise produce ordinary income taxable to the corporation under Section 337. This appears to be so whether or not the sale is made to one person in one transaction.

INSTALMENT SALE OF PROPERTY

In arranging a sale of personality so that the gain can be reported on the instalment basis (Section 453, IRC 1954), care should be exercised that no part of the initial payment can be attributable to a subsequent year because of a qualification or contingency in the contract of sale.

A taxpayer entered into a contract to sell his business in 1951 and received a down payment of less than 30 percent. However, the sale was contingent upon approval by the ICC of the transfer of the taxpayer's Certificate of Public Convenience. The contract of sale provided that upon receipt of the approval, a small additional amount of cash was to be paid (the total still being less than 30 per-

cent of the sales price) and notes for the balance were to be delivered. In the event the ICC did not approve the transfer, the down payment was to be refunded. After various negotiations, not relevant to the principle here involved, approval was obtained in 1953 and additional sums were received in that year.

The Tax Court held that the contract in 1951 was only an executory

one, that the down payment was a deposit, that it did not become the taxpayer's property until approval was obtained in 1953, and that when the down payment was added to the receipts in 1953 the total amount received in 1953 exceeded 30 percent of the sales price. Therefore, the gain from the sale could not be reported on the instalment basis. (*Daniel Rosenthal*, 32 TC No. 20.)

COMMENTARY

N. Y. STATE WITHHOLDING TAX

The enactment of the New York State "pay-as-you-go" Income Tax Act on March 12, 1959 resulted in several federal income tax problems, such as the deductibility of the 1958 state taxes paid before forgiveness, the taxability of the refund of such state taxes, and the year in which to deduct the withholding taxes and estimated tax payments in 1959 and subsequent years.

It is well established that cash basis taxpayers may deduct advance payments of state income taxes so long as the state tax law or policy permits the advance payment of the tax (IT 4054, 1951-2 CB 36). Therefore, cash basis taxpayers should deduct 1958 state income taxes paid in 1958 or in 1959 (if paid prior to March 12, 1959). Moreover, the fact that the state tax is subsequently refunded in whole or in part because of a change in law or regulations, does not invalidate the deductibility of the full amount in the year the payment was made (*Estate of Lowenstein*, 12 TC 694, acq. 1949.) The refund of the state income tax will be taxable in the year in which it is received, which will probably be 1959. (Mim. 6444, 1949-2, CB 11, as modified by Mim. 6597, 1951-1, CB 20.)

Individual taxpayers on the accrual basis should accrue a deduction for New York State income taxes for the year 1958 and report as income the corresponding amount in the year 1959 when the tax was forgiven, even though payment may never have been made to the state (IT 3849, 1947-1, CB 18.)

It is conceivable that a taxpayer who should have taken a deduction in the year 1958, but did not, may be taxed in 1959 as a result of the forgiveness and lose the deduction for 1958 by reason of the expiration of the statute of limitations. This would occur if a revenue agent made the 1959 adjustment after the statute of limitations had expired for the year 1958 (generally, April 15, 1962). It is true that Section 111 provides for the tax-free recovery of state taxes which were allowed without tax benefit in a prior taxable year. However, it is not clear that this tax benefit rule applies to items which the taxpayer failed to claim as a deduction in the earlier year. Of course, the Treasury Department or the courts may take a liberal view of the tax benefit rule and exempt the recovery from tax. However, it is recommended that either or both of the following actions be taken to protect the tax-

payer. One measure is to file a claim for refund for the year 1958 before the expiration of the statute of limitations for such year. However, the expense of the preparation of a claim and the probable examination of the return might make this procedure inadvisable. The second measure is to show the deduction of the 1958 state tax as a separate item on the 1959 tax return (even though the state tax was paid in 1958) and show the refund as a separate item of income on the same return. Under Section 1311, claiming the deduction on the 1959 return will keep the statute of limitations for the year 1958 open for one year after the deduction is determined to be unallowable for the year 1959.

Both the tax withheld from the wages during the year 1959 and the estimated tax payments made during the year 1959 will be deductible by cash basis taxpayers in the year 1959 (Revenue Ruling 56-124). If the aggregate of the withholding tax and the estimated tax payments exceeds the state tax return liability for the year 1959, the aggregate amount is nonetheless deductible for the year 1959 and the refund will be taxable in the year in which it is received, for reasons given above.

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LIMITATION ON DEDUCTIBILITY OF SUBCHAPTER S LOSSES

Section 1374(C)(2) limits a taxpayer's deduction for losses from a Subchapter S corporation to the adjusted basis of his stock and loans to the corporation. However, a question has been raised as to the amount of the adjusted basis for this purpose where stock was acquired by gift.

Code Section 1015 provides that the basis of gifted property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. For the purpose of determining loss, the same rule applies unless the fair market value of the property at the time of the gift is less than the donor's basis, in which case the fair market value is the basis to be used. It would appear that this fair-market-value rule would apply only in the event of a loss occasioned by sale or worthlessness as indicated by Section 1011. For all other purposes, the donor's basis should be applicable.

This principle was reiterated in the Committee Reports on the Technical Amendments Act of 1958 in connection with the new provisions of the act relating to increase in basis for gift taxes paid. It was stated that "where property is acquired by gift it is generally considered to have the same basis in the hands of the donee for purposes of computing gain, loss, depreciation, or amortization, as it had in the hands of the person who made the gift. Where donated property is sold at a loss, however, the recognized loss is limited to the excess of the fair market value of the property at the time (when this value is below the basis at that time) it was given to the donee, over the amount received."

The code sections comprising Subchapter S are silent as to which basis to use, and the proposed regulations do not clarify the point. However, inasmuch as the loss from a Subchapter S corporation does not result from a sale by the stockholder, the donor's basis would probably be used as the limit on the amount deductible.

Another related problem is the amount of the adjusted basis in the event of the sale of the gifted stock at a loss, after the basis has been reduced by a pass-through of losses from the electing Subchapter S corporation. What is the starting basis before reduction for the losses-donor's basis or market value? On this point, Code Section 1015 should apply and the fair market value, if less than donor's basis, would be the basis prior to reduction for losses.

Consideration should also be given in determining basis to the provisions of the 1958 Tax Law which provide for the increase in basis, under certain circumstances, for gift taxes paid.

DECLINE IN PRICE OF STOCK ACQUIRED UNDER RESTRICTED STOCK OPTION PLAN

In order to obtain the favorable tax treatment provided for restricted stock options it is necessary that the employee acquiring stock make no disposition within two years from the date the option was granted or within six months after the transfer of the stock to him.

In some cases an employee may find it necessary to exercise a restricted stock option because of time limitations when he feels the value of the stock may decline in the near future. Under these circumstances if he exercised his option and then immediately sold the stock, or did so within six months of exercise, he would be denied the advantage of the restricted stock option treatment. If certain

specific steps are taken, however, it is possible for the employee to protect himself against the decline in value which he anticipates. He can do this by purchasing a "put" (an option to sell) covering the identical shares acquired under the option on the same day such shares are acquired, and identifying the shares with the "put."

Normally, a short sale of stock or the purchase of a "put" covering stock is not regarded as a disposition. The disposition would occur when the short sale is closed or the "put" is exercised by delivery of the stock. However, a short sale or the purchase of a "put" at a time when substantially identical securities had been held for not more than six months would result in a short-term gain on closing of the short sale or exercise of the "put." However, under Section 1233 (c), in the special case where a "put" covering the identical shares acquired is purchased *on the same date*, and the shares are identified as intended to be used in exercising the "put," long-term capital gain will result if the "put" is exercised more than six months later by delivery of the identified shares.

Thus, the employee acquiring stock pursuant to a stock option arrangement can purchase a "put" on the day he acquires the shares. This purchase will not be considered a disposition. Exercise of the "put" more than six months later will be a disposition which will retain both the qualification of the restricted stock option and permit long-term capital gain on the transactions.

FOREIGN TAX CREDIT AND NON- TAXABLE FOREIGN INCOME

Mr. S., a resident of the United States, owns all of the stock of a Canadian corporation. During 1958, in accordance with a plan of reorganization, \$5,000 of earned surplus of the

Canadian corporation was converted to capital stock. Under the Canadian income tax law, this conversion, the equivalent of a stock dividend, is taxable as a dividend and Mr. S. was required to pay a \$750 Canadian non-resident tax. At the end of the year, Mr. S. received a Form NR 4, Statement of Canadian Withholding Tax, which indicated dividend income of \$5,000 and non-resident tax withheld of \$750. In addition, Mr. S. received in 1958 \$6,000 in cash dividends from other Canadian sources.

The receipt of the stock dividend does not ordinarily result in taxable income under U. S. tax law, and Mr. S. would not report this amount on his 1958 federal income tax return. The question posed was whether Mr. S. could take credit for the \$750 Canadian tax paid bearing in mind that the "income" on which the tax was paid was not taxable in the U. S.

The fact that foreign income is excludable from U. S. tax does not of itself operate to deprive the taxpayer of the foreign tax credit. Of course, the foreign tax credit is limited generally to that portion of the U. S. tax which is proportional to the ratio of taxable income from sources within the foreign country to total taxable income. Thus, where all of the foreign income is exempt from U. S. tax, the taxpayer is not entitled to a foreign tax credit. In this specific case, however, Mr. S. had other Canadian income and in making the computations on Form 1116 he would be permitted to take the full credit (Revenue Ruling 54-15).

Normally, the taxpayer has the election of taking the foreign taxes paid

either as a credit against U. S. taxes or as a deduction from adjusted gross income. It should be noted, however, that although the foreign tax credit may be taken in connection with taxes paid on excludable income, it is probable that no deduction for the foreign tax paid will be permitted where the foreign income is entirely exempt from U. S. tax. The code specifically disallows deductions allocable to income which is "wholly exempt."

ELECTION TO CAPITALIZE PAYROLL TAXES

In the April 1959 issue this department noted the Internal Revenue Service's reversal of its long-standing regulations permitting payroll taxes on construction labor to be deducted currently. Now the Service has reversed its position again and restored the former rule, which was sought uniformly by interested taxpayer groups.

When the Treasury adopted regulations under Section 266 on March 19, 1958, it reversed a procedure followed for many years of allowing a taxpayer either to deduct payroll taxes incurred in connection with construction or to elect to capitalize these taxes under Section 266. Under these regulations taxpayers were given no election but were required to capitalize payroll taxes during the construction period.

The regulations under Section 266 now have been amended by T.D. 6380, approved May 22, 1959. The amendment specifically restores the election under Section 266 to capitalize payroll taxes incurred in connection with construction or acquisition of capital assets or, alternatively, to deduct these taxes as an expense.

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